

Chapter 6: Installment Sales

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Note. Corrections were made to this workbook through January of 2025. No subsequent modifications were made. For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Peg Phillips, CPA, is a writer and editor for the University of Illinois Tax School. She has been with the program since 2003. Peg graduated from the University of Illinois with high honors in accounting and passed the CPA exam in 1989. She currently owns and operates Phillips Tax Service in Pekin, IL.

Other chapter contributors and reviewers are listed at the front of this book.

INSTALLMENT SALE DEFINED¹

An installment sale is a sale of property in which the taxpayer receives at least one payment after the year of sale. The year of sale is the one in which the taxpayer and another person enter into a binding agreement to transfer the property. To be legally binding, the agreement must include adequate consideration.²

Note. Contract laws vary by state.³ If there are any questions concerning the year that a contract became binding, practitioners may wish to contact a legal professional.

The rules for installment sales do **not** apply if the taxpayer **elects not** to use the installment method or the transaction is one for which the installment method is prohibited.

The installment sales method **cannot** be used to report the following.

- Sale **at a loss**
- Sale of inventory
- Sale of personal property by a person who regularly sells the same type of personal property on installment plans
- Sale of real property held for sale to customers in the ordinary course of a trade or business
- Sales of stocks or securities traded on an established securities market

Note. Dealers of time-shares and residential lots may treat certain sales as installment sales and report them under the installment method if they elect to pay a special interest charge. For more information, see IRC §453(l).

The buyer's obligation to make future payments to the taxpayer may be documented in various ways. It may be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to the taxpayer.

Note. Installment notes are an important tax-planning tool. Proper structuring can save taxpayers a significant amount of income tax, capital gains tax, alternative minimum tax, gift tax, generation-skipping tax, and estate tax. For information on using installment agreements as part of tax planning and other strategies, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Observation. Before making the decision to use the installment method, taxpayers should consider the following disadvantages of this income deferral provision. These include the following.

1. An installment sales contract does not receive a stepped-up basis upon the death of the owner.
2. IRC §1245 depreciation recapture is reported in full in the year of sale.⁴ This could result in the tax liability in the year of sale being greater than the installment payment received in the year of sale.
3. The requirement to report taxable income in future years increases adjusted gross income (AGI) and could reduce AGI-limited tax benefits in those years.
4. Converting real estate to an installment sale contract may have estate tax implications including the reduced ability to utilize special use valuation under IRC §2032A.

¹. IRC §453; IRS Pub. 537, *Installment Sales*.

². *Contract*. Cornell Law School Legal Information Institute. [www.law.cornell.edu/wex/contract] Accessed on May 24, 2024.

³. *Ibid*.

⁴. IRC §453(i).

GENERAL RULES⁵

For the year of the sale, the gain in an installment sale is calculated using Form 6252, *Installment Sale Income*. For each year in which the taxpayer receives a payment on the installment sale, Form 6252 is used to calculate the portion of the gain reported for that year. The taxable gain is referred to on the form as **installment sale income**.

The nature of the gain as short-term or long-term is **determined at the time of the sale**, not when the payments are received. The gain is long-term if the taxpayer owned the property for more than one year as of the property's sale date.

Caution. The tax preparer must consult state tax rules regarding installment agreements. Some states have special rules, such as the requirement of a separate state-level election, or the pledging of adequate security to ensure the collection of tax paid in connection with the installment sale transaction.

The taxpayer reports the income attributable to **depreciation recapture** in the year of the sale regardless of the amount the taxpayer received in that year. Calculating depreciation recapture is discussed later.

CALCULATING INSTALLMENT SALE INCOME

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

1. Interest income
2. Return of the property's adjusted basis
3. Gain on the sale

In each year the taxpayer receives a payment, the taxpayer must include both the interest and the gain portions in income. The taxpayer does not include in income the portion that is the return of the property's basis.

Note. Ideally, taxpayers should consult with their tax advisors before finalizing the terms of the sale. Practitioners should consider the impact of the net investment income tax (NIIT) and the brackets for capital gains rates when advising clients on the terms of the installment note. Stretching the length of the contract may result in significant tax savings if the taxpayer can avoid the NIIT and/or apply the lower capital gains rates to the gains. For more information about the NIIT, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

Caution. Practitioners should also consider adverse tax consequences from stretching the length of the contract. For example, income from the installment contract may affect taxable social security benefits or the amount of allowable deductions that are subject to AGI limitations.

Interest Income

The taxpayer must report interest as **ordinary income**. Interest is generally not included in a down payment. However, the taxpayer may have to treat part of each subsequent payment as interest, even if it is not referred to as such in the agreement with the buyer. This type of interest is referred to as **unstated interest**. The interest rate provided in the agreement is referred to as **stated interest**.

⁵ IRC §453; IRS Pub. 537, *Installment Sales*.

Adequate Interest Rate. If the agreement does not provide for an adequate interest rate, the taxpayer must recognize imputed interest income (unless certain exceptions apply, explained later). The imputed interest income may be unstated interest, original issue discount (OID), or a combination of both.

If the stated rate is not adequate, the selling price per the agreement is reduced by the unstated interest⁶ or OID.⁷ This is important because interest is subject to ordinary tax rates and gains may qualify for capital gain tax rates.

It is often easy to determine that a stated rate is **adequate** by comparing it to current market conditions. However, the rules and calculations necessary to determine that a contract's interest rate is **inadequate** are complex.

If the agreement's interest rate is at least as much as the prime rate, the interest rate is adequate. This is because the **adequacy** test is determined using **applicable federal rates (AFRs)**. AFRs are based on the average market yield of U.S. marketable obligations (e.g., U.S. savings bonds).⁸ The **prime rate** is the average lending rate posted by a majority of the top 25 U.S. commercial banks for short-term business loans.⁹ The prime rate generally exceeds the rates for U.S. government securities.

If the agreement's interest rate is greater than 0% and less than the prime rate, the rate in the agreement must be compared to a **test rate** to determine if the rate is adequate. The appendix at the end of the chapter explains how to calculate the test rate for an installment agreement. If the agreement's stated interest rate is 0% or if the agreement does not call for interest, the interest rate is clearly inadequate.

When the agreement's interest rate is inadequate, the rate used to determine the imputed interest is the lowest 3-month AFR applicable to the sale or exchange,¹⁰ compounded semiannually.¹¹ The **lowest 3-month rate** is the lowest AFR in effect for the calendar month in which there is a binding contract in writing for such sale or exchange or either of the two preceding months.¹²

Example 1. On April 19, 2024, Johan sold his tax practice to Gretta. Under the terms of the contract, Johan immediately received a vacation home in Hawaii worth \$2 million and a note payable for \$1 million. The \$1 million payment is due on April 19, 2034 (a long-term contract). Neither the contract nor the note states an interest rate.

Because the contract does not call for interest, the interest must be imputed. The imputed interest rate is the lowest AFR in effect for long-term contracts at the semiannual compounding rate for the 3-calendar-month period ending April 2024. The AFRs for these periods are as follows.

February 2024	4.14% ¹³
March 2024	4.35% ¹⁴
April 2024	4.40% ¹⁵

Accordingly, Johan's tax preparer will use 4.14% as the interest rate when making the necessary calculations to report the imputed interest on Johan's 2024 return.

⁶ IRC §483.

⁷ IRC §1274.

⁸ IRC §1274(d)(1)(C).

⁹ *Selected Interest Rates (Daily)* — H.15. Board of Governors of the Federal Reserve System. [www.federalreserve.gov/releases/h15/] Accessed on May 31, 2024.

¹⁰ For agreements subject to the imputed interest rules, both IRC §§1274 and 483(b)(2) require that the appropriate interest rate be determined using the method in §1274(d)(2). See appendix for more information.

¹¹ IRC §1274(b)(2)(B).

¹² IRC §1274(d)(2).

¹³ Rev. Rul. 2024-03, 2024-6 IRB 646.

¹⁴ Rev. Rul. 2024-04, 2024-10 IRB 686.

¹⁵ Rev. Rul. 2024-07, 2024-14 IRB 749.

Note. Imputed interest income may need to be calculated when the stated interest rate is less than market rates, or when the stated interest rate appears adequate but the sum of all principal payments due is different than the stated principal amount.¹⁶

Contract Term. There are three categories of federal rates that are determined by the weighted average maturity (WAM) term of the contract.¹⁷

- For a WAM term of three years or less, the AFR is the **short-term** rate.
- For a WAM term of over three years but not over nine years, the AFR is the **mid-term** rate.
- For a WAM term of over nine years, the AFR is the **long-term** rate.

The **WAM** is calculated by adding the weight of all payments. The weight of **each** principal payment is calculated using the following formula.¹⁸

$$\text{Weight of principal payment} = \frac{\text{Years from issue date until payment made} \times \text{Payment amount}}{\text{Debt instrument redemption price at maturity}}$$

If the **annual principal payments** are the **same each year**, the following table can be used to determine the weighted average term.¹⁹ This table is **not** appropriate for contracts if the principal payments vary.

**WAM for Equal
Annual Payments**

Contract Length	AFR Term
2-5 years	Short-term
6-17 years	Mid-term
Over 17 years	Long-term

Example 2. Edna has a note receivable of \$500,000 dated February 14, 2023. Under the terms of the note, she is to receive \$100,000 each year for the next five years. Her tax advisor determines that the WAM term of the note is three years. Using the preceding table, the advisor confirms that the short-term AFR is used to determine if the interest rate is adequate for a 5-year contract.

If the annual payments are not equal, the WAM formula must be used.

Example 3. Edith has a note receivable of \$300,000 dated February 14, 2023. Under the conditions of the note, she is to receive \$100,000 on February 15, 2024, and \$200,000 on February 15, 2025. The WAM of each payment is as follows.

- Payment 1: **1 year × \$100,000 payment ÷ \$300,000 face value = .33 year**
- Payment 2: **2 years × \$200,000 payment ÷ \$300,000 face value = 1.33 years**

The WAM is the sum of the weights for the payments, or 1.66 years. Accordingly, the WAM **term** of the note is 1.66 years.

Note. Options to renew or extend the installment agreement are taken into account when determining the contract term for these purposes.²⁰

¹⁶ IRC §1274(c).

¹⁷ IRC §1274(d)(1).

¹⁸ Treas. Reg. §1.1273-1(e)(3).

¹⁹ Ibid.

²⁰ IRC §1274(d)(3).

Calculating Unstated Interest or OID. The unstated interest or OID is the excess of the contract's stated principal amount over the imputed principal amount. The imputed principal is equal to the net present value (PV) of all the payments under the contract when the PV of the payments is based on the AFR.²¹ The formula to calculate PV is $PV = FV \div (1 + i)^n$, where FV is the future value, i is the interest rate, and n is the number of periods.²² Financial calculators, PV charts, and numerous online tools are available to make these calculations.

Adjusted Basis and Gain on Sale

As mentioned earlier, the taxpayer (or tax practitioner) must determine how much of each payment to treat as interest. After this is calculated, the taxpayer treats the rest of each payment as the selling price.

The gain on the sale is calculated using the following formula.

$$\begin{array}{r} \text{Selling price} \\ - \text{Tax-free return of the property's adjusted basis} \\ \hline \text{Gain on the sale} \end{array}$$

The gain divided by the **contract price** is the **gross profit percentage**. The reportable gain each year is the gross profit percentage multiplied by the principal payments received on the installment agreement. Additional key definitions and the mechanics of reporting the gain are explained in this section.

Selling Price. The selling price is the total cost to the buyer and includes the following.

- Any money the seller received or will receive
- The fair market value (FMV) of any property the seller received or will receive
- Any existing mortgage or other debt (such as unpaid property taxes) that the buyer pays or assumes
- Any of the selling expenses the buyer pays

The selling price does **not** include any of the following.

- Stated or unstated interest
- Any amount recalculated or recharacterized as interest
- OID

Example 4. Presley sold her vacation home on contract for deed to an unrelated party. The total sales price under the terms of the contract was \$200,000. In the year of the sale, the buyer gave her \$10,000, a motor home worth \$30,000, and a \$160,000 note payable. The note was payable in four installments of \$40,000 each, beginning the following year. The note's stated interest rate was 0%.

The AFR was 1% at the time of the sale. The PV of \$40,000 payable annually for four years at 1% interest is \$156,079.²³ Therefore, the unstated interest is \$3,921 (\$160,000 original note – \$156,079 PV of note).

For tax purposes, the selling price of the real estate is calculated as follows.

Cash received	\$ 10,000
FMV of property received	30,000
Note payable	160,000
Less: unstated interest	(3,921)
Selling price	\$196,079

²¹ IRC §1274.

²² *What Is Present Value? Formula and Calculation.* Fernando, Jason. Oct. 31, 2023. Investopedia. [www.investopedia.com/terms/p/presentvalue.asp] Accessed on May 31, 2024.

²³ Calculated using *Present Value of Annuity Calculator*. Financial Mentor. [financialmentor.com/calculator/present-value-of-annuity-calculator] Accessed on May 30, 2024.

Adjusted Basis. The property's adjusted basis **for installment sale purposes** is the sum of the following elements.

- Adjusted basis as normally defined for determining gain or loss
- Selling expenses, which include commissions, attorney fees, and any other expenses paid on the sale
- **Depreciation recapture** that must be included in income in the year of the sale (depreciation must be recaptured for **certain** IRC §1250 property and for **all** §1245 property, as discussed in depth later)

Gross Profit. Gross profit is the total gain the taxpayer recognizes using the installment method. The depreciation recapture taxed in the year of sale is not included in the gross profit. Gross profit equals the selling price less the adjusted basis as calculated for installment sale purposes.

Contract Price. The contract price is calculated as follows. Note that this formula and the formula for determining the gross profit percentage are both illustrated in **Example 5**.

The selling price	
– Mortgages, debts, and other liabilities assumed by the buyer	
+ Amount by which the mortgages, debts, and other liabilities assumed by the buyer exceed the adjusted basis for installment sale purposes	
Contract price	

Gross Profit Percentage. The gross profit percentage is the portion of principal received that is reported as gain each year. As mentioned earlier, the gross profit percentage is calculated by dividing the gain by the contract price.

Example 5. Willie sold four acres of specialty cropland to Wayland for \$100,000. In the sale agreement, Wayland assumed the mortgage of \$80,000 and agreed to pay the remaining \$20,000 over five years at \$4,000 per year plus interest of 3%. Willie's adjusted basis in the land was \$30,000. The excess of the assumed mortgage over Willie's basis was \$50,000 (\$80,000 mortgage – \$30,000 adjusted basis). The contract price for the exchange was calculated as follows.

Selling price	\$100,000
Less: mortgage assumed by Wayland	(80,000)
Plus: excess of mortgage over basis	<u>50,000</u>
Contract price	\$ 70,000

Willie's gain was also \$70,000 (\$100,000 selling price – \$30,000 adjusted basis). Accordingly, his gross profit percentage is 100%, and he will report each \$4,000 payment as gain attributable to the sale. This is in addition to the \$50,000 he reports in the year of the sale.

Amount to Report as Installment Sale Income. To calculate the annual amount reported as installment sale income for the tax year, the payments the seller receives each year (less interest) are multiplied by the gross profit percentage. In certain circumstances, the taxpayer may be treated as having received a payment, even though the taxpayer received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment to the seller. Payments received or considered received are covered later.

Reporting Installment Sale Income

Form 6252 is used to calculate the gross profit percentage in the year of sale. It also is used to report the taxable portion of principal payments received each year. The taxable gain flows to Schedule D, *Capital Gains and Losses*, or Form 4797, *Sales of Business Property*, or both, depending on the taxpayer's use of the property.

Line 1 of Form 6252 is used to describe the property sold and must also include one of the following codes based on how the property was used at the time of the sale.²⁴

1. As a timeshare or residential lot
2. By individual taxpayers for **personal purposes**
3. In the trade or business of farming²⁵
4. For all other purposes, including in a trade or business, rental activity, or other income producing manner.

Example 6. On January 16, 2022, Jim sold 100 acres of swampland in Florida on an installment sale. He purchased the acres for \$45,000 on March 2, 1974. He held the property as an investment and did not use it in any business ventures. Hattie, the buyer, built a custom home in the center of the acreage.

The selling price was \$300,000. Jim's total selling expenses were \$30,000, which consisted of \$21,000 in commissions he paid to the realtor and \$9,000 he paid an attorney to draw up the necessary legal documents.

Jim received a \$100,000 down payment on the sale. According to the terms of the note, he will receive the remaining \$200,000 in four annual installments of \$50,000, plus interest, beginning in January 2023.

Jim's 2022 Form 6252 and page 1 of his Schedule D follow. As shown on Form 6252, Jim's gross profit on the sale was \$225,000 (line 16) and his gross profit percentage was 75% (line 19).

²⁴ Instructions for Form 6252 (2023). See also IRC §1275(b)(3) referencing IRC §212.

²⁵ Farming for these purposes is defined within the meaning of IRC §§2032A(e)(4) or (5).

For Example 6

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.

Go to www.irs.gov/Form6252 for the latest information.

OMB No. 1545-0228

2022
Attachment
Sequence No. **67**

Name(s) shown on return

Jim Stafford

Identifying number

***-**-9848

1 Description of property **2-100 Acres Investment Real Estate****2a** Date acquired (mm/dd/yyyy) **03/02/1974****b** Date sold (mm/dd/yyyy) **01/16/2022****3** Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No**4** Reserved for future use ☐ Yes ☒ No**Part I Gross Profit and Contract Price.** Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. Don't include interest, whether stated or unstated	5	300,000
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	300,000
8	Cost or other basis of property sold	8	45,000
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	45,000
11	Commissions and other expenses of sale	11	30,000
12	Income recapture from Form 4797, Part III (see instructions)	12	
13	Add lines 10, 11, and 12	13	75,000
14	Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions	14	225,000
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	225,000
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	0
18	Contract price. Add line 7 and line 17	18	300,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

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	0.7500
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21	Payments received during year (see instructions). Don't include interest, whether stated or unstated	21	100,000
22	Add lines 20 and 21	22	100,000
23	Payments received in prior years (see instructions). Don't include interest, whether stated or unstated	23	
24	Installment sale income. Multiply line 22 by line 19	24	75,000
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	75,000

Part III Related Party Installment Sale Income. **Don't** 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 IRS that tax avoidance wasn't 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 2022 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	

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 13601R

Form **6252** (2022)

For Example 6

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to www.irs.gov/ScheduleD for instructions and the latest information.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2022

Attachment
Sequence No. **12**

Name(s) shown on return

Jim Stafford

Your social security number

*****-**-9848**

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ Yes ☒ No

If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11 75,000
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then, go to Part III on the back				15 75,000

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2022

In years after the year of sale, the taxpayer generally must complete Form 6252 each year that they receive principal payments. The taxpayer reports the interest received on Schedule B, *Interest and Ordinary Dividends*. If the seller holds a mortgage on the property and the buyer uses the property as a personal residence, the seller must provide their tax identification number to the buyer.²⁶ In addition, the seller must report the buyer's name, address, and tax identification number on Schedule B or as an attachment to the return.²⁷

Note. Form 6252 must be filed each year of the installment agreement, even if no principal payments are received. In addition, part I must **now** be completed each year.²⁸



Practitioner Planning Tip

The requirement to complete part I of Form 6252 every year after the year of sale only started in 2023. Therefore, practitioners should review all prior returns for new clients with installment sales that started prior to 2022.

6

Example 7. Use the same facts as **Example 6**. In 2023, Jim received \$50,000 of principal and \$20,000 of interest on the note. On his 2023 Form 6252, lines 1 to 4 and part I show the same information as shown on his 2022 Form 6252. In part II, he reports the \$50,000 he received in 2023 and multiplies that by the 75% gross profit percentage to determine that \$37,500 of the principal he received in 2023 is taxable. This flows to Schedule D (not shown). He reports the \$20,000 of interest income on Schedule B.

Jim's 2023 Form 6252 and Schedule B follow.

²⁶ Instructions for Schedule B.

²⁷ Ibid.

²⁸ Instructions for Form 6252.

For Example 7

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. Go to www.irs.gov/Form6252 for the latest information.	OMB No. 1545-0228 2023 Attachment Sequence No. 67
Name(s) shown on return Jim Stafford		Identifying number ***-**-9848
1 Description of property 2 - 100 Acres Investment Real Estate		
2a Date acquired (mm/dd/yyyy) 03/02/1974		b Date sold (mm/dd/yyyy) 01/16/2022
3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No		
4 Reserved for future use ☐ Yes ☒ No		
Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.		
5 Selling price including mortgages and other debts. Don't include interest, whether stated or unstated		5 300,000
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 7 300,000		
8 Cost or other basis of property sold 8 45,000		
9 Depreciation allowed or allowable 9		
10 Adjusted basis. Subtract line 9 from line 8 10 45,000		
11 Commissions and other expenses of sale 11 30,000		
12 Income recapture from Form 4797, Part III (see instructions) 12		
13 Add lines 10, 11, and 12 13 75,000		
14 Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions 14 225,000		
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 16 225,000		
17 Subtract line 13 from line 6. If zero or less, enter -0- 17 0		
18 Contract price. Add line 7 and line 17 18 300,000		
Part II Installment Sale Income. Complete this part for all years of the installment agreement.		
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 0.7500		
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0- 20 0		
21 Payments received during year (see instructions). Don't include interest, whether stated or unstated 21 50,000		
22 Add lines 20 and 21 22 50,000		
23 Payments received in prior years (see instructions). Don't include interest, whether stated or unstated 23 100,000		
24 Installment sale income. Multiply line 22 by line 19 24 37,500		
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 37,500		
Part III Related Party Installment Sale Income. Don't 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 IRS that tax avoidance wasn't 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 2023 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		

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Cat. No. 13601R

Form **6252** (2023)

6

If the property sold was used in a trade, business, or rental activity, then the profit calculated on Form 6252 flows to Form 4797 instead of directly to Schedule D. Special rules (discussed later) apply to property for which depreciation was allowed or allowable. In addition, if the seller sold the property in the course of their trade or business and they receive mortgage interest during the year of \$600 or more, the seller is required to report the interest they received on Form 1098, *Mortgage Interest Statement*.²⁹

Example 8. Use the same facts as **Example 6**, except Jim received rental income from the property during the time he owned it. In 2023, the taxable gain flows to line 4 of Form 4797, which follows. Note that the Form 6252, line 1 description code is now “4” as shown next.

Note. If the taxpayer reports payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, then the taxpayer may not be able to provide all the information asked for on Form 6252. In this situation, the taxpayer should provide as many details as possible in a statement attached to Form 6252.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))
Attach to your tax return.
Go to www.irs.gov/Form4797 for instructions and the latest information.

OMB No. 1545-0184
2023
Attachment
Sequence No. **27**

Name(s) shown on return
Jim Stafford

Identifying number
*****-**-9848**

1a Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions

1b Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets

1c Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
3	Gain, if any, from Form 4684, line 39						3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4 37,500
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6	Gain, if any, from line 32, from other than casualty or theft						6
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows						7 37,500
Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.							
Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
8	Nonrecaptured net section 1231 losses from prior years. See instructions						8
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions						9

Part II Ordinary Gains and Losses (see instructions)

²⁹ Instructions for Form 1098.

For Example 8

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. Go to www.irs.gov/Form6252 for the latest information.	OMB No. 1545-0228 2023 Attachment Sequence No. 67
Name(s) shown on return Jim Stafford		Identifying number ***-**-9848
1 Description of property 4 - 100 Acres Rental Real Estate		
2a Date acquired (mm/dd/yyyy) 03/02/1974		b Date sold (mm/dd/yyyy) 01/16/2022
3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year		
☐ Yes ☒ No		
4 Reserved for future use		
☐ Yes ☒ No		
Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.		
5 Selling price including mortgages and other debts. Don't include interest, whether stated or unstated		5 300,000

SELLING PRICE REDUCED

If the selling price is reduced after the year of sale, then the gross profit on the sale also changes. The taxpayer (or tax preparer) must recalculate the gross profit percentage for the remaining payments. The taxpayer's remaining gain is spread over future installments.

The new gross profit percentage is calculated using the following formula.

$$\begin{array}{r}
 \text{Reduced selling price} \\
 - \text{Adjusted basis (as defined earlier)} \\
 - \text{Any installment sale income previously reported} \\
 \hline
 \text{Remaining deferred gain} \\
 \div \text{Future installments} \\
 \hline
 \text{New gross profit percentage}
 \end{array}$$

Example 9. In 2022, Milo sold land with a \$40,000 basis for \$100,000. The gross profit was \$60,000 (\$100,000 proceeds – \$40,000 basis). He received a \$20,000 down payment and a note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 8% interest, beginning in 2023. The gross profit percentage is 60% (\$60,000 gross profit ÷ \$100,000 proceeds). Milo reported a gain of \$12,000 (\$20,000 annual payment × 60% gross profit percentage) on each payment received in 2022 and 2023.

In 2024, Milo and the buyer agree to reduce the purchase price to \$85,000. Accordingly, the remaining unpaid purchase price is \$45,000 (\$85,000 purchase price – \$20,000 paid in 2022 – \$20,000 paid in 2023), and the payments for 2024, 2025, and 2026 are reduced to \$15,000 each.

The new 46.67% gross profit percentage is calculated as follows.

Reduced selling price	\$85,000
Less: adjusted basis	(40,000)
Less: any installment sale income previously reported (\$12,000 in 2022 + \$12,000 in 2023)	(24,000)
Remaining deferred gain	\$21,000
Future installments	÷ 45,000
New gross profit percentage	46.67%

Milo will report a gain of \$7,000 (46.67% gross profit percentage × \$15,000 annual payment) on each of the \$15,000 installments due in 2024, 2025, and 2026.

ELECTING OUT OF THE INSTALLMENT METHOD³⁰

When taxpayers **elect not** to use the installment method, they must report the entire gain in the year of sale. To make the opt-out election, the taxpayer reports the sale on Form 4797 and/or Form 8949, *Sales and Other Dispositions of Capital Assets*, depending on the taxpayer's use of the asset. Form 6252 is not used.

Note. For taxpayers filing Schedule F, *Profit or Loss From Farming*, this choice can be a very powerful tax planning tool. Farmers may have grain delivered, priced, sold, and held for payment in the following year using a valid deferred payment agreement. Farmers may either report the income under the installment method as income in the following year or elect out of the installment method and report the income in the current year. This opt-out election can be made for each contract and is accomplished by reporting the income on the current year Schedule F.³¹ For more information on installment sales and farmers, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 11: Agricultural Issues and Rural Investments.

To calculate the amount of gain to report, the taxpayer adds the FMV of the buyer's installment obligation to the other consideration received during the year. The taxpayer must calculate the FMV of the buyer's installment obligation, regardless of whether the taxpayer would actually be able to sell it.

When the taxpayer uses the cash method of accounting, the FMV of the obligation is **never treated as less than the FMV of the property sold** minus any other consideration received. Thus, for most individual taxpayers, the FMV of the **obligation** is treated as equal to the note's stated principal amount.

A taxpayer using the accrual method of accounting treats the total amount payable under the installment obligation as the amount realized in the year of sale.³² For this purpose, interest (whether stated or unstated) and OID are not considered part of the amount payable.

Note. If the amount payable is otherwise fixed but the timing of the payments is contingent on outside factors, additional calculations are necessary. For more information, see Temp. Treas. Reg. §15a.453-1T(d)(2).

The election must be made by the due date, including extensions, for filing the tax return for the year the sale takes place. If the taxpayer timely files the tax return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). To make the election out of the installment method with an amended return, the taxpayer writes "Filed pursuant to section 301.9100-2" at the top of the amended return and sends it to the IRS location at which the original return was filed.

Once made, the election can only be revoked with the IRS's approval. A revocation is retroactive. The election cannot be revoked if either of the following applies.

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

³⁰ IRS Pub. 537, *Installment Sales*.

³¹ IRS Pub. 225, *Farmer's Tax Guide*.

³² Temp. Treas. Reg. §15a.453-1T(d)(2)(ii)(A).

PAYMENTS RECEIVED³³

For each year an installment sale payment is received or treated as received, the taxpayer must calculate gain from the installment sale. In certain situations, the taxpayer is considered to have received a payment, even though the buyer does not pay the taxpayer directly. These situations occur when the buyer assumes or pays any of the taxpayer's debts (such as a loan) or pays any of the taxpayer's expenses (such as a sales commission). However, in many cases, the buyer's assumption of a debt is treated as a recovery of the basis rather than as a payment. This is discussed later.

BUYER PAYS SELLER'S EXPENSES

When the buyer pays any of the taxpayer's expenses related to the sale of the property, it is considered a payment to the taxpayer in the year of sale. These expenses are included in the selling and contract prices when calculating the gross profit percentage.

BUYER ASSUMES MORTGAGE

If the buyer assumes or pays off the taxpayer's mortgage or otherwise takes the property subject to the mortgage, the rules that apply depend on whether the mortgage is less than or equal to the basis, or more than the basis. Other rules apply if the mortgage is canceled.

Mortgage Less than or Equal to Basis

When the buyer assumes a mortgage that is not more than the installment sale basis in the property, it is not considered a payment to the taxpayer. Instead, it is considered a recovery of the taxpayer's basis. The contract price is the selling price minus the mortgage.

Example 10. In 2024, Billie sells property with an adjusted basis of \$19,000. She incurs selling expenses of \$1,000. Therefore, her installment sale basis is \$20,000.

The buyer, Minnie, assumes the existing mortgage of \$15,000 and makes a \$2,000 down payment. In addition, Minnie agrees to pay Billie \$8,000 over the next four years at \$2,000 per year, plus 12% interest.

- The selling price is \$25,000 (\$15,000 mortgage + \$2,000 down payment + \$8,000 installment payments).
- The gross profit is \$5,000 (\$25,000 selling price – \$20,000 installment sale basis).
- The contract price is \$10,000 (\$25,000 selling price – \$15,000 mortgage).
- The gross profit percentage is 50% (\$5,000 gross profit ÷ \$10,000 contract price).

Billie reports 50% of each \$2,000 payment she receives as gain from the sale. She also reports the interest as ordinary income.

Mortgage More than Basis

When a buyer assumes a mortgage that is more than the installment sale basis in the property, the seller recovers the entire basis in the year of the sale. The part of the mortgage greater than the seller's basis is treated as a payment received in the year of sale. The gross profit percentage is always 100% in this situation.

To calculate the contract price, the taxpayer subtracts the mortgage from the selling price. This is the total amount the taxpayer will receive directly from the buyer. The taxpayer adds this to the payment the taxpayer is considered to have received (the difference between the mortgage and the installment sale basis). The contract price is then the same as the gross profit from the sale.

³³ IRS Pub. 537, *Installment Sales*.

Example 11. In 2023, William sells 10 acres of hunting ground for \$9,000. His basis is \$4,400 and he incurs \$600 of selling expenses; therefore, his installment sale basis is \$5,000. The buyer, Harry, assumes an existing mortgage of \$6,000 and agrees to pay the remaining \$3,000 in \$750 annual installments, plus 8% interest, over the next four years.

The part of the mortgage that is more than the installment sale basis is \$1,000 (\$6,000 mortgage – \$5,000 basis). This \$1,000 is considered part of the installment contract. It is added to the \$3,000 difference between the selling price and the mortgage. Therefore, \$4,000 is the contract price.

On William's 2023 Form 6252, his gain of \$4,000 (\$9,000 selling price – \$4,400 basis – \$600 selling expenses) is reported on lines 14 and 16. The contract price reported on line 18 is \$4,000 (\$1,000 excess mortgage + \$3,000 to be received in future years). His gross profit percentage is 100%. The entire \$1,000 difference between the mortgage and the installment sale basis is treated as 2023 income.

For Example 11

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.

Go to www.irs.gov/Form6252 for the latest information.

OMB No. 1545-0228

2023
Attachment
Sequence No. **67**

Name(s) shown on return

Identifying number

William Fits

***-**-4666

- 1** Description of property **2-10 Acres Recreational Woodland**
- 2a** Date acquired (mm/dd/yyyy) **02/14/2014** **b** Date sold (mm/dd/yyyy) **02/14/2023**
- 3** Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No
- 4** Reserved for future use ☐ Yes ☒ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

- | | | |
|--|-----------|--------------|
| 5 Selling price including mortgages and other debts. Don't include interest, whether stated or unstated | 5 | 9,000 |
| 6 Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions) | 6 | 6,000 |
| 7 Subtract line 6 from line 5 | 7 | 3,000 |
| 8 Cost or other basis of property sold | 8 | 4,400 |
| 9 Depreciation allowed or allowable | 9 | |
| 10 Adjusted basis. Subtract line 9 from line 8 | 10 | 4,400 |
| 11 Commissions and other expenses of sale | 11 | 600 |
| 12 Income recapture from Form 4797, Part III (see instructions) | 12 | |
| 13 Add lines 10, 11, and 12 | 13 | 5,000 |
| 14 Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions | 14 | 4,000 |
| 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 | 4,000 |
| 17 Subtract line 13 from line 6. If zero or less, enter -0- | 17 | 1,000 |
| 18 Contract price. Add line 7 and line 17 | 18 | 4,000 |

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

- | | | |
|---|-----------|---------------|
| 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 | 1.0000 |
| 20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0- | 20 | 1,000 |
| 21 Payments received during year (see instructions). Don't include interest, whether stated or unstated | 21 | |
| 22 Add lines 20 and 21 | 22 | 1,000 |
| 23 Payments received in prior years (see instructions). Don't include interest, whether stated or unstated | 23 | |
| 24 Installment sale income. Multiply line 22 by line 19 | 24 | 1,000 |
| 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 | 1,000 |

Part III Related Party Installment Sale Income. **Don't** 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 IRS that tax avoidance wasn't 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 2023 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 | |

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Cat. No. 13601R

Form **6252** (2023)

Mortgage Canceled

When the buyer of the property is the person who holds the mortgage, the debt is canceled, not assumed. The seller is considered to receive a payment equal to the outstanding canceled debt.

Example 12. Mary loaned John \$45,000 in 2018 in exchange for a note and a mortgage on a tract of land John owned. On April 1, 2024, she buys the land from him for \$70,000. At that time, \$30,000 of her loan to him is outstanding. She agrees to forgive this \$30,000 debt and to pay him \$20,000 plus interest on August 1, 2025, and \$20,000 plus interest on August 1, 2026. Mary does not assume an existing mortgage; instead, she cancels the \$30,000 debt John owed her. John must treat the \$30,000 as a payment received at the time of the sale.

BUYER ASSUMES OTHER DEBTS

When the buyer assumes any other debts, such as a loan or back taxes, the assumption of debt **may be** considered a payment to the seller in the year of sale. The rules that apply to mortgages also apply to the following types of debt that the buyer assumes.

- Debts related to ownership of the property the taxpayer sold, such as a mortgage, lien, overdue interest, or back taxes
- Debts incurred in the ordinary course of a business, such as a balance due for inventory the taxpayer purchased

When the buyer assumes any other type of debt, such as a personal loan or the legal fees relating to the sale, it is treated as if the buyer paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to the taxpayer in the year of sale.

PROPERTY USED AS A PAYMENT

When the taxpayer receives property other than money from the buyer, it is considered a payment in the year received unless the like-kind exchange provisions apply. Like-kind exchanges are discussed later. Generally, the “payment” is equal to the property’s FMV on the date the taxpayer receives it.

When the property the buyer gives the taxpayer is **payable on demand (e.g., a third-party note) or readily tradable (e.g., publicly traded stocks)**, the amount the taxpayer considers as payment in the year received is determined under the following rules.

1. If the taxpayer uses the **cash method of accounting**, then the payment is equal to the property’s FMV on the date the taxpayer receives it. If the property is third-party debt, then any payments the taxpayer later receives from the third party are not considered part of the installment sale. The excess of the note’s face value over its FMV is interest.
2. If the taxpayer uses the **accrual method of accounting**, then the payment is equal to the face amount of the obligation on the date the taxpayer receives it.
3. If the obligation includes OID or unstated interest, then the payment equals the stated redemption price at maturity appropriately adjusted to reflect OID or total unstated interest.

Observation. If the seller is also the lender in an installment sale transaction and wants to avoid treating the note receivable as being fully taxable in the year of sale, the note payable must **not be payable on demand** and must **not be readily tradable**.³⁴ This prevents the note payable from being treated as a payment in the year of sale and allows income to be recognized as an installment obligation in future years.

³⁴ IRC §453(f)(4).

Any third-party debt that the taxpayer receives from the buyer that is **not payable on demand** is **not** considered a payment. This is true even if the debt is guaranteed by a third party, including a government agency.

Example 13. Barry owes Debbie \$50,000 as evidenced by a note he gave her in 2021. Under the terms of the note, he pays 5% interest each year. Principal of \$25,000 is due in 2026, and the balance of \$25,000 is due in 2027. There are no provisions allowing Debbie to demand payment prior to the due dates.

In October 2024, Debbie buys a 2017 Luxury Fiesta motorhome from Ron. Debbie assigns the note from Barry to Ron. In addition, she gives Ron \$2,000 and a note for \$20,000 from her payable to Ron. Debbie's note is payable over four years beginning in 2025, plus 8% interest.

At the time of the sale, the **FMV of Barry's note is \$30,000**, as determined by a valuation expert. This amount, not the \$50,000 principal balance on the note, is considered a payment to Ron in the year of sale.

The sales price is \$52,000 (\$30,000 note FMV + \$2,000 paid to Ron + \$20,000 note from Debbie to Ron). Ron treats \$32,000 (\$30,000 + \$2,000) as payments in 2024, the year of sale. The taxable portion of payments from Debbie to Ron in 2025 through 2028 will be determined under the installment sales rules.

At the time of the sale, Barry's note has an FMV equal to 60% of its face value (\$30,000 ÷ \$50,000). Therefore, 60% of each principal payment Ron receives from Barry is a nontaxable return of capital. The remaining 40% is interest income. If Barry pays Ron as scheduled in 2026 and 2027, then Ron will report \$10,000 (\$25,000 annual payment × 40% interest allocation) as interest income each year.

INSTALLMENT OBLIGATION USED AS SECURITY³⁵

If the taxpayer uses an installment obligation to secure any of their debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is called the **pledge rule**. The purpose of the pledge rule is to keep taxpayers from extracting cash from an installment sale without incurring any immediate tax. The rule applies if the selling price of the property sold on installment is over \$150,000. It does **not** apply to the following dispositions.

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

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

- The date the debt becomes secured
- The date the taxpayer receives the debt proceeds

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

Payment on a debt is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or part of the debt with the installment obligation.

³⁵ IRC §453A; IRS Pub. 537, *Installment Sales*, pp. 8–9 (2023).

Limit

The 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 sale, **minus**
2. Any payments received on the installment obligation before the date the net debt proceeds are treated as a payment.

Accelerated Reporting

The pledge rule accelerates the reporting of the installment obligation payments. Payments received on the obligation after it was pledged are not reported until the payments received exceed the amount reported under the pledge rule.

Example 14. Mary Jane received a \$500,000 note from Conrad for the sale of her commercial building in 2022. The note is payable over 10 years, with interest. She did not receive any payments on the note from Conrad in 2022.

In January 2023, Mary Jane uses the note as collateral to borrow \$200,000 from Nancy. Under the pledge rule, Mary Jane reports the \$200,000 she borrowed from Nancy in 2023 as if it constituted principal payments from Conrad in 2023.

Mary Jane also receives \$50,000 from Conrad in March 2023. Conrad's \$50,000 payment is disregarded for installment reporting purposes. Conrad's payments will be disregarded until they total more than the \$200,000 Mary Jane reports in 2023 under the pledge rule.

Example 15. Use the same facts as **Example 14**, except Mary Jane uses the note as collateral in 2023 after she has received a total of \$350,000 of principal payments from Conrad. The limit in 2023 on the amount she must report under the pledge rule is \$150,000 (\$500,000 contract price – \$350,000 payments). In this instance, she will not have any principal payments to report in the following years because she has already reported receiving the entire contract principal.

Exception

The pledge rule does not apply to pledges made after December 17, 1987, in order to refinance a debt, under the following circumstances.

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

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt as long as a person other than the creditor or a person related to the creditor provides the refinancing. This exception applies only to refinancing that does not exceed the principal of the original debt immediately before the refinancing. Any excess is treated as a payment on the installment obligation.

MONETIZED INSTALLMENT SALES³⁶

In 2023, the IRS and the Department of the Treasury identified certain monetized installment sale transactions and substantially similar transactions as **listed transactions**.³⁷ Material advisors and participants in these transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose. In 2024, the IRS identified monetized installment sales as one of the top schemes for the year in their list of Dirty Dozen scams.³⁸

Note. For more information on the 2024 Dirty Dozen list, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

A listed transaction is a transaction that the IRS has:

1. Determined to be a tax avoidance arrangement, and
2. Identified by a notice, regulation, or other form of published guidance as a listed transaction.³⁹

A **monetized installment sale transaction** generally includes the following characteristics.

- A seller of appreciated property, or their representative, finds a buyer willing to purchase the property for cash or other assets.
- The seller makes an agreement to sell the property to an intermediary in exchange for an installment obligation, wherein the intermediary pays interest to the seller.
- The seller then transfers the property to the intermediary, who either briefly holds the title or never takes it, before passing it to the buyer in exchange for the buyer's payment.
- Additionally, the seller secures a loan with an agreement for interest payments matching those received from the intermediary.
- Both the installment agreement and the loan involve interest payments over the same periods, with the principal due in a lump sum (balloon payment) towards the end of their terms.
- The intermediary forwards the sale proceeds, minus certain fees, to the lender to finance the seller's loan or holds them in an escrow account, with the lender as a beneficiary.
- The lender commits to repaying these amounts to the intermediary over the installment obligation's duration.
- The seller reports the sale as an installment under IRC §453 on their federal income tax return, deferring gain recognition until receiving the principal balloon payment.

³⁶ *Treasury and IRS issue proposed regulations identifying certain monetized installment sales as listed transactions*. Aug. 3, 2023. IRS. [www.irs.gov/newsroom/treasury-and-irs-issue-proposed-regulations-identifying-certain-monetized-installment-sales-as-listed-transactions] Accessed on Jun. 10, 2024.

³⁷ Prop. REG-109348-22, IR-2023-139 (Aug. 3, 2023).

³⁸ See *Dirty Dozen: High-income filers vulnerable to illegal tax schemes; face risk from improper art donation deductions, charitable remainder annuity trusts, monetized installment sales*. Apr. 10, 2024. IRS. [www.irs.gov/newsroom/dirty-dozen-high-income-filers-vulnerable-to-illegal-tax-schemes-face-risk-from-improper-art-donation-deductions-charitable-remainder-annuity-trusts-monetized-installment-sales] Accessed on Jun. 10, 2024.

³⁹ Treas. Reg. §1.6011-4(b)(2).

In this scheme, the seller gets the majority of the proceeds, but improperly delays recognizing the gain on the appreciated property until the final payment on the installment note, which is often many years later. Unfortunately, promoters may look for taxpayers who are seeking to defer the recognition of gain once they sell the appreciated property by organizing an abusive shelter through selling monetized installment sales. Accordingly, the IRS targets the promoters by requiring material advisors (who profit from the scheme) to alert the Treasury Department about the arrangement.

Note. For issues specific to farmers, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 11: Agricultural Issues and Rural Investments.

MATERIAL ADVISOR

A **material advisor** is a person who:⁴⁰

1. Provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and
2. Directly or indirectly derives gross income in excess of the threshold amount for such aid, assistance, or advice.

For listed transactions, the threshold amount is \$10,000 for a natural person and \$25,000 for all other entities,⁴¹ whereas for non-listed transactions, the threshold amount is \$50,000 for a natural person and \$250,000 for all other entities.

REPORTING REPORTABLE TRANSACTIONS⁴²

Form 8886, *Reportable Transaction Disclosure Statement*, generally must be filed for each reportable transaction. The form must:

- Describe the expected tax treatment and all potential tax benefits expected from the transaction,
- Describe any tax result protection regarding the transaction, and
- Identify and describe the transaction in sufficient detail for the IRS to understand the tax structure of the transaction and identify all the parties involved in the transaction.

ESCROW ARRANGEMENTS⁴³

Occasionally, a sales agreement or a later agreement may require the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. **These types of sales cannot be reported on the installment method.** The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, the taxpayer relies on the escrow arrangement for the rest of the payments, rather than on the buyer.

When the taxpayer makes an installment sale and in a later year establishes an irrevocable escrow account to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation.

⁴⁰ IRC §6111(b)(1).

⁴¹ Treas Reg. §301.6111-3(b)(3).

⁴² *Abusive tax shelters and transactions*. May 3, 2024. IRS. [www.irs.gov/businesses/corporations/abusive-tax-shelters-and-transactions] Accessed on Jun. 10, 2024; Instructions for Form 8886.

⁴³ IRS Pub. 537, *Installment Sales*.

However, if an escrow arrangement imposes a substantial restriction on the seller's right to receive the sale proceeds, the sale can be reported on the installment method if it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the **buyer**.⁴⁴ This means that it must have a **real and definite restriction placed on the seller** or a specific economic benefit conferred on the buyer.

Example 16. Alba enters into an asset purchase and sale agreement with Benny, the seller, to purchase business assets. The total purchase price for the assets is \$400,000. Alba and Benny agree that the \$400,000 purchase price will be placed into an escrow account for a 2-year period. The escrow agreement is being used to protect Alba from any breach of representations made by Benny regarding the assets purchased by Alba, and to ensure the assets are free of any encumbrances. After two years, Benny will receive the funds. During the two years that the funds are in escrow, however, Benny will be entitled to quarterly interest payments for the interest earned on the \$400,000 while in escrow.

Benny's access to the escrow funds is limited to quarterly interest payments, and the escrow arrangement is used to protect Alba, the purchaser. Benny's right to the trust funds is therefore subject to a substantial restriction or condition. Benny may use the installment sale rules for the sale transaction.⁴⁵

Note. For the general rule that funds deposited in escrow are constructively received by the seller, disqualifying the transaction from installment sale treatment, see *Oden v. Comm'r*.⁴⁶ For the substantial restriction or condition exception to the *Oden* rule, see *Stiles v. Comm'r*.⁴⁷ For additional authority and details regarding the substantial restriction or condition exception, see also Rev. Rul. 77-294.

DEPRECIATION RECAPTURE AND UNRECAPTURED \$1250 GAIN⁴⁸

When the taxpayer sells property for which the taxpayer claimed or could have claimed a depreciation deduction, the taxpayer must report any depreciation **recapture** income in the **year of sale**. This is true regardless of whether an installment payment was received that year. Depreciation recapture is taxed as ordinary income.

Depreciation **recapture** is limited to the gain realized on the disposition and includes the following.

1. All depreciation **allowed or allowable** on §1245 property (personal property)
2. Depreciation in **excess of straight-line** on §1250 property (depreciable real estate)

Example 17. Darrel sold his concrete slab jacking equipment to Scott in December 2023 for a note payable of \$15,000, plus interest. Under the terms of the note, Scott agreed to pay \$500 per month beginning on January 31, 2024. These payments will continue until the note is paid in full.

Darrel originally purchased the equipment for \$25,000. As of 2023, it was fully depreciated.

Darrel reported the entire \$15,000 selling price as depreciation recapture on his 2023 Form 4797. He did not file Form 6252, because all of the profit was taxed in 2023. In subsequent years, Darrel will only report the interest received on the note.

Observation. The use of an installment sale may be impractical for businesses who made use of bonus depreciation or the IRC §179 deductions in prior years because the §1245 recapture rules apply. The tax liability may exceed the cash received in the year of sale.

⁴⁴ Rev. Rul. 79-91, 1979-1 CB 179.

⁴⁵ This example is based on Ltr. Rul. 200521007 (Feb. 25, 2005).

⁴⁶ *Oden v. Comm'r*, 56 TC 569 (1971).

⁴⁷ *Stiles v. Comm'r*, 69 TC 558 (1978), *acq.* 1978-2 CB 3.

⁴⁸ IRS Pub. 544, *Sales and Other Dispositions of Assets*.

Essentially, only the gain in excess of the original purchase price qualifies for the lower long-term capital gains tax rates. Any portion of the gain that is a recovery of a deduction is generally taxed at ordinary income tax rates. However, there is a limit on the tax rate for recovery of straight-line depreciation on §1250 property.

Gain from the sale of §1250 property that is attributable to the accumulated depreciation allowed or allowable under the straight-line method is called **unrecaptured gain** and is **taxed as ordinary income up to the maximum rate of 25%**. The taxpayer enters the amount of unrecaptured gain on the “Unrecaptured Section 1250 Gain Worksheet,” which is part of the Schedule D instructions.

The taxable gain on principal payments received on the installment basis is **first** allocated to the unrecaptured §1250 gain. This continues each year until the taxpayer claims the entire amount of unrecaptured gain.⁴⁹ The remainder of the gain is taxed as a short-term or long-term capital gain, depending on the holding period of the sold assets.

Example 18. Ursula sold residential rental property on contract for deed on September 9, 2023, for \$200,000. The property was originally purchased for \$145,000 in September 2008. The land value at the time of purchase was \$10,000. Of the \$135,000 depreciable basis, her accumulated allowed or allowable depreciation at the time of the sale was **\$73,635**.⁵⁰

Ursula’s adjusted basis in the property was \$71,365 (\$145,000 cost – \$73,635 accumulated depreciation). Her total gain was \$128,635 (\$200,000 sales price – \$71,365 adjusted basis). This is also her gross profit under the installment agreement. The gain is composed of the following.

Unrecaptured gain	\$ 73,635
Long-term capital gain	<u>55,000</u>
Total gain	\$128,635

Under the terms of the contract, Ursula received a down payment of \$20,000 in 2023. She will receive the remaining principal over 15 years beginning in January 2024.

Ursula’s gross profit percentage is 64.32% (\$128,635 gain ÷ \$200,000 sales price). Her 2023 taxable gain is \$12,864 (\$20,000 principal received × 64.32% gross profit percentage). The entire \$12,864 is taxed as unrecaptured §1250 gain. Ursula will not claim any of the gain as long-term capital gains until she has claimed the entire \$73,635 of depreciation.

On her 2023 return, Ursula reported the sale in part III of Form 4797 and on Form 6252. Line 32 of Form 4797 is marked “N/A” in accordance with the instructions for Form 6252, line 12, about reporting the installment sale on Form 4797. The taxable portion of the sale flowed from Form 6252 to line 4 of Form 4797. Pages of Ursula’s Forms 6252 and 4797 follow.

⁴⁹ Treas. Reg. §1.453-12(a).

⁵⁰ Calculated using MACRS, straight-line, mid-month convention, 27.5 years.

For Example 18

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.

Go to www.irs.gov/Form6252 for the latest information.

OMB No. 1545-0228

2023
Attachment
Sequence No. **67**

Name(s) shown on return

Ursula Gwinn

Identifying number

***-**-2222

- 1** Description of property **4 - Residential Rental Property**
- 2a** Date acquired (mm/dd/yyyy) **09/09/2008** **b** Date sold (mm/dd/yyyy) **09/09/2023**
- 3** Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No
- 4** Reserved for future use ☐ Yes ☒ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. Don't include interest, whether stated or unstated	5	200,000
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	200,000
8	Cost or other basis of property sold	8	145,000
9	Depreciation allowed or allowable	9	73,635
10	Adjusted basis. Subtract line 9 from line 8	10	71,365
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III (see instructions)	12	0
13	Add lines 10, 11, and 12	13	71,365
14	Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions	14	128,635
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	128,635
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	0
18	Contract price. Add line 7 and line 17	18	200,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

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	0.6432
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21	Payments received during year (see instructions). Don't include interest, whether stated or unstated	21	20,000
22	Add lines 20 and 21	22	20,000
23	Payments received in prior years (see instructions). Don't include interest, whether stated or unstated	23	
24	Installment sale income. Multiply line 22 by line 19	24	12,864
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	12,864

Part III Related Party Installment Sale Income. **Don't** 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 IRS that tax avoidance wasn't 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 2023 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 | |

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 13601R

Form **6252** (2023)

For Example 18

Form 4797 Department of the Treasury Internal Revenue Service	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) Attach to your tax return. Go to www.irs.gov/Form4797 for instructions and the latest information.	OMB No. 1545-0184 2023 Attachment Sequence No. 27
Name(s) shown on return Ursula Gwinn		Identifying number ***-**-2222
1a Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions		1a
b Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets		1b
c Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets		1c
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)		
2	(a) Description of property	(b) Date acquired (mo., day, yr.)
(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition
(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)	
3	Gain, if any, from Form 4684, line 39	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	
6	Gain, if any, from line 32, from other than casualty or theft	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	
Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	
Part II Ordinary Gains and Losses (see instructions)		
10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):		
11	Loss, if any, from line 7	
12	Gain, if any, from line 7 or amount from line 8, if applicable	
13	Gain, if any, from line 31	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	
17	Combine lines 10 through 16	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.	
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	

For Example 18

Form 4797 (2023)

Page **2**

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Residential Rental Property	09/09/2008	09/09/2023
B			
C			
D			

These columns relate to the properties on lines 19A through 19D.		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1a before completing.)	200,000			
21	Cost or other basis plus expense of sale	145,000			
22	Depreciation (or depletion) allowed or allowable	73,635			
23	Adjusted basis. Subtract line 22 from line 21.	71,365			
24	Total gain. Subtract line 23 from line 20	128,635			
25	If section 1245 property:				
a	Depreciation allowed or allowable from line 22				
b	Enter the smaller of line 24 or 25a				
26	If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.				
a	Additional depreciation after 1975. See instructions	0			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a. See instructions	0			
c	Subtract line 26a from line 24. If residential rental property or line 24 isn't more than line 26a, skip lines 26d and 26e	128,635			
d	Additional depreciation after 1969 and before 1976				
e	Enter the smaller of line 26c or 26d				
f	Section 291 amount (corporations only)				
g	Add lines 26b, 26e, and 26f	0			
27	If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.				
a	Soil, water, and land clearing expenses				
b	Line 27a multiplied by applicable percentage. See instructions				
c	Enter the smaller of line 24 or 27b				
28	If section 1254 property:				
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions				
b	Enter the smaller of line 24 or 28a				
29	If section 1255 property:				
a	Applicable percentage of payments excluded from income under section 126. See instructions				
b	Enter the smaller of line 24 or 29a. See instructions				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	128,635
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	0
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	N/A

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33	
34	Recomputed depreciation. See instructions	34	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	

Form **4797** (2023)

6

Part I of Form 6252 is required to be completed each subsequent year that the installment agreement is in place. The total amount of unrecaptured §1250 gain from the sale is generally the lesser of line 9 or line 16 of Form 6252.

Line 23 in part II of Form 6252 reports the total of principal payments that the taxpayer received in prior years. Accordingly, if the prior years' Forms 6252 were completed correctly, it is possible to determine the portion of the gain that must be taxed under these rules in the current year by comparing lines 9 and 23.

Real property for which accelerated depreciation was taken may be subject to both depreciation recapture and tax on unrecaptured gain. The depreciation recapture portion of the gain is taxed in the year of sale.

As mentioned earlier, depreciable real estate is §1250 property and personal property is §1245 property. **However, any §179 deduction or bonus depreciation deduction taken on real property is considered §1245 property for depreciation recapture purposes.**⁵¹ The amount of depreciation recapture for §1250 property treated as personal property under the §1245 rules is the excess of accelerated depreciation over straight-line depreciation, multiplied by the applicable percentage.

The applicable percentage is 100% for most real property. However, the applicable percentage for qualified low-income housing decreases when held for more than 100 full months.

Note. See IRS Pub. 544, *Sales and Other Dispositions of Assets*, for more information on qualified low-income housing. In addition, IRS Pub. 544 contains information about rules applicable to corporations other than S corporations under IRC §291, which is not covered in this material.

Example 19. On July 1, 2015, Quinn opened a nightclub in a leased facility in Juneau, Alaska. The facility is owned by Neeley, an unrelated party. Prior to opening night, Quinn invested \$60,000 in improvements to the interior of the building.

On his 2015 tax return, Quinn claimed \$30,000 of bonus depreciation on the leasehold improvements in addition to straight-line depreciation on the remaining \$30,000.⁵²

As part of his agreement with his landlord, if Quinn did not renew his lease, Neeley had to purchase the leasehold improvements at a price based on any appreciation attributable to the renovations made by Quinn. In 2023, Quinn closes the club and gives notice that he will not renew the lease effective December 1, 2023. He sells the equipment at auction and sells the leasehold improvements for \$75,000 to Neeley in an installment sale. Quinn receives \$5,000 in 2023 as a down payment. The remaining \$70,000 is due over seven years, with interest at 10%.

Step 1. Quinn's total gain on the sale of the property is calculated on **page 2 of Form 4797**, as shown later. Line 20 represents the total sales price. Lines 21 through 23 show the calculation of his adjusted basis of \$14,000 (\$60,000 cost – \$46,000 accumulated depreciation). Line 24 shows his total gain of \$61,000 (\$75,000 sales price – \$14,000 adjusted basis).

Step 2. The depreciation recapture is calculated on **line 26 of Form 4797**. In this step, line 26a is calculated as follows.

Bonus depreciation taken in 2015	\$30,000
Straight-line depreciation from July 2, 2015 through December 1, 2023	16,000
Total accumulated depreciation	\$46,000
Straight-line depreciation allowable without bonus depreciation	(32,000)
Additional depreciation reported on line 26a	\$14,000

⁵¹ IRC §1245(a)(3)(C) and Treas. Reg. §1.168(k)-1(f)(3).

⁵² Per the 2015 Instructions for Form 4562, *Depreciation and Amortization*, 50% bonus depreciation applied to qualified leasehold improvement property as defined in IRC §§168(e)(6) and (k)(3).

- Step 3.** The additional depreciation on line 26a is multiplied by the applicable percentage of 100% to arrive at the \$14,000 reported on lines 26b and 26g. (The applicable percentage is 100% because the leasehold improvements are not related to qualified low-income housing rental real estate.) Line 32 shows N/A, in accordance with the instructions for Form 6252 regarding line 31 of Form 4797, because the remaining balance of the gain is reported on Form 6252. After completing the mechanics of page 2 of Form 4797, the \$14,000 flows to line 13 of page 1 of Form 4797 (shown later).
- Step 4.** The balance of Quinn's gain of \$47,000 (\$61,000 total gain – \$14,000 depreciation recapture) is reported as an installment sale on **Form 6252** (shown later). The \$14,000 adjusted basis is calculated on lines 7 through 10. Line 12 shows the depreciation recapture from Form 4797, page 2. The amounts on lines 10 and 12 are the same because the accelerated depreciation Quinn used in 2015 was 50% bonus depreciation.
- Step 5.** Because the depreciation recapture is taxed in 2023, it is added to the adjusted basis on Form 6252. The gross profit on line 14 is the remaining gain after taking into account the depreciation recapture. Line 18 shows the contract price of \$75,000.
- Step 6.** Quinn's gross profit percentage is 62.67%, as shown on line 19. The \$5,000 he receives on the contract sale in 2023 is reported on line 21 and multiplied by the gross profit percentage. This results in \$3,133 of installment sale income, which is shown on line 24.

Note. Line 25 applies to IRC §§1252, 1254, and 1255 property, which are not discussed in this chapter.

- Step 7.** Line 26 of Form 6252 is carried to Form 4797, part I.
- Step 8.** The amount of Quinn's contract gain that represents unrecaptured §1250 depreciation is **not** shown anywhere on his return. His **unrecaptured gain** is equal to the \$32,000, as calculated in Step 2 (the amount of depreciation calculated on the straight-line basis as if he had not used bonus depreciation). During the contract period, Quinn treats 100% of the taxable portion of the contract payments as unrecaptured gain until he claims the entire \$32,000. Accordingly, in 2024, he will use \$3,133 as the amount on line 4 of the Unrecaptured Section 1250 Gain Worksheet (shown later).

The remaining gain of \$15,000 (\$47,000 total gain – \$32,000 unrecaptured gain) is taxed at the applicable long-term capital gains rates in effect for the years Quinn reports the payments received.

Quinn's Form 4797, Form 6252, and Unrecaptured Section 1250 Gain Worksheet follow.

For Example 19

Form **4797**Department of the Treasury
Internal Revenue Service**Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))Attach to your tax return.
Go to www.irs.gov/Form4797 for instructions and the latest information.

OMB No. 1545-0184

2023Attachment
Sequence No. **27**

Name(s) shown on return

Quinn Phillips

Identifying number

*****-**-7777**

- 1a** Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions
- 1b** Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets
- 1c** Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets

1a**1b****1c****Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

- 3** Gain, if any, from Form 4684, line 39
- 4** Section 1231 gain from installment sales from Form 6252, line 26 or 37
- 5** Section 1231 gain or (loss) from like-kind exchanges from Form 8824
- 6** Gain, if any, from line 32, from other than casualty or theft
- 7** Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows

3**4****5****6****7****3,133****0****3,133****Partnerships and S corporations.** Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.**Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

- 8** Nonrecaptured net section 1231 losses from prior years. See instructions
- 9** Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions

8**9****Part II Ordinary Gains and Losses** (see instructions)**10** Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

- 11** Loss, if any, from line 7
- 12** Gain, if any, from line 7 or amount from line 8, if applicable
- 13** Gain, if any, from line 31
- 14** Net gain or (loss) from Form 4684, lines 31 and 38a
- 15** Ordinary gain from installment sales from Form 6252, line 25 or 36
- 16** Ordinary gain or (loss) from like-kind exchanges from Form 8824
- 17** Combine lines 10 through 16

11**12****13****14****15****16****17****14,000****14,000****18** For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.**a** If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions**b** Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4**18a****18b****14,000**

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 130861

Form **4797** (2023)

For Example 19

Form 4797 (2023)

Page **2**

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Leasehold Improvements	07/01/2015	12/01/2023
B			
C			
D			

These columns relate to the properties on lines 19A through 19D.		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1a before completing.)	20 75,000			
21	Cost or other basis plus expense of sale	21 60,000			
22	Depreciation (or depletion) allowed or allowable	22 46,000			
23	Adjusted basis. Subtract line 22 from line 21.	23 14,000			
24	Total gain. Subtract line 23 from line 20	24 61,000			
25	If section 1245 property:				
a	Depreciation allowed or allowable from line 22	25a			
b	Enter the smaller of line 24 or 25a	25b			
26	If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.				
a	Additional depreciation after 1975. See instructions	26a 14,000			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a. See instructions	26b 14,000			
c	Subtract line 26a from line 24. If residential rental property or line 24 isn't more than line 26a, skip lines 26d and 26e	26c 47,000			
d	Additional depreciation after 1969 and before 1976	26d			
e	Enter the smaller of line 26c or 26d	26e			
f	Section 291 amount (corporations only)	26f			
g	Add lines 26b, 26e, and 26f	26g 14,000			
27	If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.				
a	Soil, water, and land clearing expenses	27a			
b	Line 27a multiplied by applicable percentage. See instructions	27b			
c	Enter the smaller of line 24 or 27b	27c			
28	If section 1254 property:				
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a			
b	Enter the smaller of line 24 or 28a	28b			
29	If section 1255 property:				
a	Applicable percentage of payments excluded from income under section 126. See instructions	29a			
b	Enter the smaller of line 24 or 29a. See instructions	29b			

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30 61,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31 14,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32 N/A

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33	
34	Recomputed depreciation. See instructions	34	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	

Form **4797** (2023)

6

For Example 19

Form 6252 Department of the Treasury Internal Revenue Service Name(s) shown on return Quinn Phillips	Installment Sale Income Attach to your tax return. Use a separate form for each sale or other disposition of property on the installment method. Go to www.irs.gov/Form6252 for the latest information.	OMB No. 1545-0228 2023 Attachment Sequence No. 67
		Identifying number ***-**-7777

1 Description of property **4 - Leasehold Improvements**

2a Date acquired (mm/dd/yyyy) **07/01/2015** **b** Date sold (mm/dd/yyyy) **12/01/2023**

3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No

4 Reserved for future use ☐ Yes ☒ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5 Selling price including mortgages and other debts. Don't include interest, whether stated or unstated	5	75,000
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	75,000
8 Cost or other basis of property sold	8	60,000
9 Depreciation allowed or allowable	9	46,000
10 Adjusted basis. Subtract line 9 from line 8	10	14,000
11 Commissions and other expenses of sale	11	
12 Income recapture from Form 4797, Part III (see instructions)	12	14,000
13 Add lines 10, 11, and 12	13	28,000
14 Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions	14	47,000
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	47,000
17 Subtract line 13 from line 6. If zero or less, enter -0-	17	0
18 Contract price. Add line 7 and line 17	18	75,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

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	0.6267
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21 Payments received during year (see instructions). Don't include interest, whether stated or unstated	21	5,000
22 Add lines 20 and 21	22	5,000
23 Payments received in prior years (see instructions). Don't include interest, whether stated or unstated	23	
24 Installment sale income. Multiply line 22 by line 19	24	3,133
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	3,133

Part III Related Party Installment Sale Income. **Don't** 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 IRS that tax avoidance wasn't 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 2023 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	

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Cat. No. 13601R

Form **6252** (2023)

For Example 19

Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records



If you aren't reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

1. If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the smaller of line 22 or line 24 of Form 4797 for that property. If you didn't have any such property, go to line 4. If you had more than one such property, see instructions	1.	
2. Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1	2.	
3. Subtract line 2 from line 1	3.	
4. Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year. See instructions	4.	3,133
5. Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"	5.	
6. Add lines 3 through 5	6.	3,133
7. Enter the smaller of line 6 or the gain from Form 4797, line 7	7.	3,133
8. Enter the amount, if any, from Form 4797, line 8	8.	
9. Subtract line 8 from line 7. If zero or less, enter -0-	9.	3,133
10. Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain. See instructions	10.	
11. Enter the total of any amounts reported to you as "unrecaptured section 1250 gain" on a Schedule K-1, Form 1099-DIV, or Form 2439 from an estate, a trust, a real estate investment trust, or a mutual fund (or other regulated investment company) or in connection with a Form 1099-R	11.	
12. Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you didn't make an entry in Part I of Form 4797 for the year of sale. See instructions	12.	
13. Add lines 9 through 12	13.	3,133
14. If you had any section 1202 gain or collectibles gain or (loss), enter the total of lines 1 through 4 of the 28% Rate Gain Worksheet . Otherwise, enter -0-	14.	0
15. Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	15.	(0)
16. Enter your long-term capital loss carryovers from Schedule D, line 14; and Schedule K-1 (Form 1041), box 11, code D*	16.	(0)
17. Combine lines 14 through 16. If the result is a (loss), enter it as a positive amount. If the result is zero or a gain, enter -0-	17.	0
18. Unrecaptured section 1250 gain. Subtract line 17 from line 13. If zero or less, enter -0-. If more than zero, enter the result here and on Schedule D, line 19	18.	3,133

* If you are filing Form 2555 (relating to foreign earned income), see the footnote in the Foreign Earned Income Tax Worksheet in the Instructions for Form 1040 before completing this line.

SALES TO RELATED PERSONS AND LATER DISPOSITIONS⁵³

A special rule applies to installment agreements with related persons if **both** of the following conditions apply.

- The related person resells or disposes of the property within **two years** of the purchase from the taxpayer.
- The disposition by the related person occurs before all of the payments are made under the installment agreement.

Related persons for these purposes include the following. The definition for these related parties is found in IRC §1239, rather than in IRC §§267 or 318.

1. Members of a family, including only brothers and sisters, spouses, ancestors, and lineal descendants of the taxpayer(s)
2. A partnership or estate, and a partner or beneficiary
3. A trust (other than an IRC §401(a) employees trust) and a beneficiary
4. A trust and an owner of the trust
5. Two corporations that are members of the same controlled group as defined in §267(f)
6. The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and a person (if an individual, including members of the individual's family) who directly or indirectly controls such an organization
8. An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the corporation's outstanding stock
9. A fiduciary of a trust and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the corporation's outstanding stock
10. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust
11. Any two S corporations if the same persons own more than 50% in value of each corporation's outstanding stock
12. An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of each corporation's outstanding stock
13. A corporation and a partnership if the same persons own more than 50% in value of the corporation's outstanding stock and more than 50% of the capital or profits interest in the partnership
14. An executor and a beneficiary of an estate unless the sale is in satisfaction of a pecuniary bequest

Because of this special rule, when a taxpayer makes an installment sale to a related party, they must include Form 6252 with their return for the year of sale and for the two years after the year of sale.⁵⁴ For each year, the taxpayer must indicate if the related party sold or otherwise disposed of the property. This applies regardless of whether the taxpayer received any principal payments in those years.

⁵³ IRS Pub. 537, *Installment Sales*.

⁵⁴ Instructions for Form 6252.

Under the special rule, the taxpayer must treat at least a portion of the amount the related person realizes from the second disposition **as if the taxpayer received it** at the time of the second disposition. The amount recognized by the taxpayer is calculated as follows.

1. Determine the **lesser** of:
 - a. The amount realized on the second disposition, or
 - b. The contract price on the first disposition.
2. Subtract the sum of the payments received by the taxpayer on the contract through the end of the tax year.

An important exception applies to this rule when tax avoidance is not a principal purpose of the transaction. This is discussed later. If the amount received on the second disposition is more than the original contract price of the first disposition, the taxpayer must claim the entire deferred gain from the first disposition in the year of the second disposition.

Example 20. In 2022, Margaret sold farmland to her son, Brent, for \$500,000. This was to be paid in five equal payments over five years, plus adequate stated interest on the balance due. Her installment sale basis for the farmland was \$200,000, and the property was not subject to any outstanding liens or mortgages. Her gross profit is \$300,000 (\$500,000 sale price – \$200,000 basis) and her gross profit percentage is 60% (\$300,000 gross profit ÷ \$500,000 contract price).

She received \$100,000 in 2022 and included \$60,000 in income for that year (\$100,000 × 60%). On her 2022 Form 6252 (not shown), Margaret marked on line 3 that the property was sold to a related party. She provided Brent's name, address, and social security number on line 27 and indicated on line 28 that Brent did not resell the property in 2022.

Brent makes no improvements to the property and sells it to an unrelated party, Maryland Dreams, Inc., in 2023 for \$600,000 after making the \$100,000 payment due that year. He does not make any additional payments to her in 2023.

Margaret uses the following calculation to determine that she must report \$300,000 as if it were received in 2023 because Brent sold the property.

A. Amount realized on second disposition	\$600,000
B. Contract price on first disposition	500,000
Lesser of A or B	\$500,000
Less: the sum of payments from Brent in 2022 and 2023	(200,000)
Amount treated as received because of the second disposition	\$300,000

Margaret's Form 6252 for 2023 is shown next. Line 26 shows the \$60,000 income from the 2023 installment payment of \$100,000, and line 37 shows the installment sale income from the \$300,000 treated as received.

In 2023, Margaret reported the entire remaining deferred profit on the sale. Therefore, she will not report any additional gain when she receives the subsequent installment payments from Brent.

For Example 20

Form 6252 Department of the Treasury Internal Revenue Service Name(s) shown on return Margaret Forrest	Installment Sale Income Attach to your tax return. Use a separate form for each sale or other disposition of property on the installment method. Go to www.irs.gov/Form6252 for the latest information.	OMB No. 1545-0228 2023 Attachment Sequence No. 67
		Identifying number ***-**-8488

1	Description of property 3 - 40 Acres Farm Land		
2a	Date acquired (mm/dd/yyyy) Various	b	Date sold (mm/dd/yyyy) 03/01/2022
3	Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☒ Yes ☐ No		
4	Reserved for future use ☐ Yes ☐ No		

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. Don't include interest, whether stated or unstated	5	500,000
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	500,000
8	Cost or other basis of property sold	8	200,000
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	200,000
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	200,000
14	Subtract line 13 from line 5. If zero or less, don't complete the rest of this form. See instructions	14	300,000
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	300,000
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	0
18	Contract price. Add line 7 and line 17	18	500,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

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	0.6000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21	Payments received during year (see instructions). Don't include interest, whether stated or unstated	21	100,000
22	Add lines 20 and 21	22	100,000
23	Payments received in prior years (see instructions). Don't include interest, whether stated or unstated	23	100,000
24	Installment sale income. Multiply line 22 by line 19	24	60,000
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	60,000

Part III Related Party Installment Sale Income. **Don't** complete if you received the final payment this tax year.

27	Name, address, and taxpayer identifying number of related party Brent Atwood 16 Scion Way New Windsor MD 21776 ***-**-6788		
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 IRS that tax avoidance wasn't 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	600,000
31	Enter contract price from line 18 for year of first sale	31	500,000
32	Enter the smaller of line 30 or line 31	32	500,000
33	Total payments received by the end of your 2023 tax year (see instructions)	33	200,000
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	300,000
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	180,000
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	180,000

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Cat. No. 13601R

Form **6252** (2023)

If the amount realized on the second disposition is less than the contract price of the first disposition, the taxpayer will **not** have claimed the entire gain in the year of the second disposition. In this case, the taxpayer applies the gain attributable to future payments first to the previously recognized gain. The taxpayer does not recognize any of the remaining gain until after the gain received exceeds the previously taxed gain.

Example 21. Use the same facts as **Example 20**, except Brent sells the land for \$300,000. The amount **treated** as received in 2023 is \$100,000, which is calculated as follows.

A. Amount realized on second disposition	\$300,000
B. Contract price on first disposition	500,000
Lesser of A or B	\$300,000
Less: the sum of payments from Brent in 2022 and 2023	<u>(200,000)</u>
Amount treated as received because of the second disposition	\$100,000

The \$100,000 payment Margaret receives in 2024 is applied against the amount treated as received in 2023. The payments in 2025 and 2026 are not treated as received in 2023 and will be taxed accordingly.

This rule requiring current recognition of deferred gain does **not** apply to a second disposition if the taxpayer can show to the IRS's satisfaction that neither disposition had as one of its principal purposes the avoidance of federal income tax. The IRS automatically recognizes that there was no tax avoidance purpose in the following situations.

1. Involuntary dispositions including foreclosures on the property and bankruptcy of the related person
2. Involuntary conversions if the first disposition occurred before the threat of conversion
3. A second disposition that is also an installment sale if the payment terms under the installment resale are substantially equal to or longer than those for the first installment sale (this exception does not apply if the resale terms permit significant deferral of recognition of gain from the first sale)

Note. A transfer after the death of one of the parties (if this death occurs before the death of the other party) to the installment agreement is not treated as a second disposition.

SALES OF DEPRECIABLE PROPERTY TO A CONTROLLED ENTITY⁵⁵

If the taxpayer sells **depreciable property** to a **controlled entity** in an installment sale, the taxpayer is generally prohibited from reporting the sale using the installment method.⁵⁶ However, the installment method may be used if no significant tax deferral benefit is derived from the sale,⁵⁷ **and** the taxpayers can prove to the IRS's satisfaction that avoidance of federal income tax was not one of the principal purposes of the sale.⁵⁸ There is no prohibition against using the installment method for such sales if the assets are not depreciable by the purchaser.

Controlled entities for these purposes include the following related parties.

- A person and all controlled entities with respect to that person⁵⁹
- A taxpayer and any trust in which such taxpayer (or their spouse) is a beneficiary, unless their interest in the trust is a remote contingent interest⁶⁰
- An executor of an estate and a beneficiary of that estate except in the case of a sale or exchange in satisfaction of a pecuniary bequest⁶¹
- Two or more partnerships in which the same person owns, directly or indirectly, more than 50% of the capital interests or the profits interests⁶²

If the taxpayers cannot prove that the sale of depreciable property among these related persons was not for the purpose of avoiding federal income tax, all noncontingent payments to be received are considered received in the year of sale. The FMV of any contingent payments is also considered received in the year of sale. If the FMV of the contingent payments cannot be reasonably determined, the basis in the property is recovered proportionately.⁶³ The purchaser cannot increase the basis of the property acquired in the sale before the seller includes a like amount in income.⁶⁴

LIKE-KIND EXCHANGE⁶⁵

When a taxpayer trades real estate used in business or as investment property in a like-kind exchange, reporting the gain can be postponed. The taxpayer treats the property received in a like-kind exchange as if it were a continuation of the relinquished property. The taxpayer is **not required to report any part of the gain** if they receive only like-kind property. However, if the taxpayer also receives money or other property (boot) in the exchange, they must report the gain to the extent of the money and the FMV of the other property received.

Note. For more information about like-kind exchanges, see IRS Pub. 544.

⁵⁵ IRC §453(g).

⁵⁶ IRC §453(g)(1).

⁵⁷ IRS Pub. 537, *Installment Sales*.

⁵⁸ IRC §453(g)(2). See also *Tecumseh Corrugated Box Co. v. Comm'r*, 94 TC 360 (1990).

⁵⁹ As defined in IRC §1239(c).

⁶⁰ As defined in IRC §1239(b).

⁶¹ *Ibid.*

⁶² As described in IRC §707(b)(1)(B).

⁶³ IRC §453(g)(1)(B)(ii).

⁶⁴ IRC §453(g)(1)(C).

⁶⁵ IRS Pub. 537, *Installment Sales*.

If the taxpayer receives an installment obligation in the exchange in addition to like-kind property, the following rules determine the installment sale income each year.

- The contract price is reduced by the FMV of the like-kind property received in the trade.
- The gross profit is reduced by any gain on the trade that can be postponed.
- Like-kind property received in the trade is not considered payment on the installment obligation.

Example 22. In 2023, Georgia trades real estate with an installment sale basis of \$400,000 for like-kind property having a \$200,000 FMV.⁶⁶ She also receives an installment note for \$800,000 in the trade. Under the terms of the note, she receives \$100,000 (plus interest) in 2024 and the balance of \$700,000 (plus interest) in 2025.

Relevant calculations for the installment sale are shown in the following table.

Installment note	\$ 800,000		
FMV of like-kind property received	200,000		
Selling price	\$1,000,000	\$1,000,000	
Installment sale basis	(400,000)		
Gross profit	\$ 600,000		\$600,000
Less: FMV of property received		(200,000)	
Contract price		\$ 800,000	÷ 800,000
Gross profit percentage			75%
Payment received in 2024		(100,000)	× 100,000
Gain reported in 2024			\$ 75,000
Balance on installment note		\$ 700,000	
Gross profit percentage		× 75%	
Gain reported in 2025		\$ 525,000	

Georgia did not report any gain in 2023 because the like-kind property she received was not treated as a payment for calculating gain. As shown in the table, she reports a \$75,000 gain in 2024 and a \$525,000 gain in 2025.

Note. A deferred exchange is one in which the taxpayer transfers business or investment property and later receives like-kind property. Under this type of exchange, the person receiving the property may be required to place funds in an escrow account or trust. If certain rules are met, these funds are not considered a payment until the taxpayer has the right to receive the funds or, if earlier, the end of the exchange period.⁶⁷

⁶⁶ Based on example in IRS Pub. 537, *Installment Sales*, p. 11.

⁶⁷ See Treas. Reg. §1.1031(k)-1(j)(2).

CONTINGENT PAYMENT SALE⁶⁸

A contingent payment sale is one in which the total selling price cannot be determined by the end of the tax year of sale. This happens, for example, when the taxpayer sells a business and the selling price includes a percentage of the business's profits in future years.

If the selling price cannot be determined by the end of the tax year, the taxpayer must use different rules to calculate the contract price and the gross profit percentage than those the taxpayer uses for an installment sale with a fixed selling price.

Note. For rules on using the installment method for a contingent payment sale, see Treas. Reg. §15a.453-1(c). For unstated interest or OID related to a contingent sale, see Treas. Regs. §§1.1275-4(c) and 1.483-4.

SINGLE SALE OF SEVERAL ASSETS⁶⁹

If the taxpayer sells **different types** of assets in a single sale, the taxpayer must identify each asset to determine whether they can use the installment method to report the sale of that asset. The taxpayer must also allocate part of the selling price to each asset. However, if the taxpayer sells assets that constitute a trade or business, different rules apply. This is discussed later.

Ideally, both parties in an arm's-length transaction have agreed to the allocation of the selling price. If not, the taxpayer must allocate the selling price to the assets based on their FMVs. If debt is assumed by the buyer, the FMV of the property is reduced by the debt amount.

A taxpayer reports the sale of separate and unrelated assets of the same type under a single contract as one transaction for the installment method. However, if an asset is sold at a loss, its disposition cannot be reported on the installment method. It must be reported separately. The remaining assets sold at a gain are reported together.

Example 23. In 2023, Albert sells three separate and unrelated parcels of real property (E, M, and C) under a single contract with a total selling price of \$130,000. The total selling price consists of a cash payment of \$20,000, the buyer's assumption of a \$30,000 mortgage on parcel M, and an installment obligation of \$80,000 payable in eight annual installments of \$10,000, plus interest at 8% per year.

The installment sale basis for each parcel is \$15,000. The net gain is \$85,000 (\$130,000 sales price – (3 properties × \$15,000 basis)). Albert reports the gain using the installment method.

The sales contract does not allocate the selling price or the cash payment received in the year of sale among the individual parcels. According to the county assessor, the FMVs of parcels E, M, and C are \$60,000, \$60,000, and \$10,000, respectively.

The installment sale basis for parcel C is more than its FMV. Consequently, it is sold at a loss and has to be treated separately. Albert allocates the total selling price and the amounts received in the year of sale between parcel C and the remaining parcels.

⁶⁸ IRS Pub. 537, *Installment Sales*.

⁶⁹ *Ibid.*

Of the total \$130,000 selling price, Albert allocates \$60,000 each to parcels E and M and \$10,000 to parcel C. Because E and M are both sold at a gain, he reports them as one installment sale. He allocates the \$20,000 received in 2023 based on the proportionate FMV, net of the mortgage assumed. The allocation is calculated as follows.

	Parcels E and M	Parcel C
FMV	\$120,000	\$10,000
Less: mortgage assumed	(30,000)	(0)
Net FMV	\$ 90,000	\$10,000
Allocated percentage of net FMV	90%	10%
Payments in 2023:		
\$20,000 × allocated percentage	\$ 18,000	\$ 2,000
Plus: excess of parcel M mortgage over installment sale basis (\$30,000 — \$15,000)	15,000	0
Payments received and considered received	\$ 33,000	\$ 2,000

Albert does not report the sale of parcel C on the installment method because the sale results in a loss. He reports this loss of \$5,000 (\$10,000 selling price — \$15,000 installment sale basis) in 2023. If the real estate parcels were used in Albert's trade or business, the \$5,000 loss would be reported on Form 4797 and is fully deductible in the year of the sale. If the real estate parcels were Albert's investment property, the \$5,000 loss would be reported on Form 8949, which flows to Schedule D, subject to capital loss limitations.

The installment note payments are applied to the parcels based on their allocated percentages in future years. Of the annual \$10,000 payment, 90% is attributed to parcels E and M. **The 10% attributed to C is not reported on future returns.**

SALE OF A BUSINESS⁷⁰

To determine whether any of the gain on the sale of the business is allowed to be reported on the installment method, the taxpayer must allocate the total selling price and the payments received in the year of sale between each of the following classes of assets.

1. Assets sold at a loss
2. Real and personal property eligible for the installment method
3. Real and personal property **ineligible** for the installment method, including:
 - a. Inventory
 - b. Dealer property
 - c. Stocks and securities

The gain on the sale of property that is ineligible for the installment method **must be reported in the year of sale**, regardless of whether the taxpayer will receive payments in later years. The amount that the taxpayer receives (or will receive) for **inventory** is reported as ordinary business income. The basis in the inventory is included in the cost of goods sold. Any part of the selling expenses allocated to inventory is an ordinary business expense.

⁷⁰ Ibid.

RESIDUAL METHOD

To allocate the sales price, taxpayers must use **the residual method** for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under IRC §743(b).

A group of assets constitutes a trade or business if:

- Goodwill or going concern value could, under any circumstances, attach to the assets **or**
- The use of the assets would constitute an active trade or business under IRC §355.

The business's sales price is first reduced by any cash, checking, or savings accounts included in the sale. The sales price is then allocated among the following assets in proportion to (but not more than) their FMV on the purchase date in the following order.

1. **Certificates of deposit**, U.S. government securities, foreign currency, and actively traded personal property, including stock and securities
2. **Accounts receivable**, other debt instruments, and assets that the taxpayer marks to market at least annually for federal income tax purposes (see Treas. Reg. §1.338-6(b)(2)(iii) for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property)
3. Property of a kind that would properly be included in **inventory** if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business
4. All other assets **except** IRC §197 **intangibles**
5. Other §197 intangibles **except goodwill and going concern** value
6. **Goodwill and going concern value** (regardless of whether they qualify as §197 intangibles)

If an asset is includable in more than one category, it should be included in the lower number category. For example, if an asset is described in both categories 4 and 6, include it in 4.

AGREEMENT

Ideally, the agreement will include the allocation of the sales price to the assets. This agreement is binding on both parties unless the IRS determines the amounts are not appropriate.

Example 24. Sebastian owned The Mermaid's Song, a music store that he operated as a sole proprietor. He sold the business on June 4, 2023. The sales price of \$220,000 includes all inventory, furnishings, equipment, a delivery truck, the business name, and the building. Selling expenses are \$11,000. Sebastian's adjusted basis in the property at the time of the sale follows (with the building depreciated using the straight-line method).

Asset	Original Purchase Price	Accumulated Depreciation	Adjusted Basis
Inventory	\$ 8,000	\$ 0	\$ 8,000
Furnishings and equipment	126,000	40,160	85,840
Truck	24,000	18,624	5,376
Building	45,000	9,000	36,000
Land	15,000	0	15,000
Total	\$218,000	\$67,784	\$150,216

After consulting with their attorneys and accountants, Sebastian and the buyer agree that the FMV of the assets included in the purchase price are as shown in the following table. All of the selling costs are allocated proportionally.

Asset	Sales Price	Selling Expenses	Adjusted Basis	Gain
Inventory	\$ 10,000	\$ 500	\$ 8,000	\$ 1,500
Furnishings and equipment	95,000	4,750	85,840	4,410
Truck	6,500	325	5,376	799
Building	48,000	2,400	36,000	9,600
Land	42,000	2,100	15,000	24,900
Goodwill	18,500	925	0	17,575
Total	\$220,000	\$11,000	\$150,216	\$58,784

Not all of the assets qualify to be reported on the installment method. The following tables explain the breakdown of the sale for reporting purposes.

Asset	IRC Section	Lesser of Gain or Accumulated Depreciation	Depreciation Recapture	Unrecaptured §1250 Gain
Inventory	IRC §471	\$ 0	\$ 0	\$ 0
Furnishings and equipment	IRC §1245	4,410	4,410	0
Truck	IRC §1245	799	799	0
Building	IRC §1250	9,000	0	9,000
Land	N/A	0	0	0
Goodwill (IRC §197)	IRC §1245	0	0	0
Totals			\$5,209	\$9,000

Asset	Qualified for Installment Method	Reported in Return on...
Inventory	No, sale must be reported as business income	Schedule C
Furnishings, equipment	No, entire gain is subject to depreciation recapture	Form 4797, part III
Truck	No, entire gain is subject to depreciation recapture	Form 4797, part III
Building	Yes	Form 4797, part III and Form 6252
Land	Yes	Form 4797, part I and Form 6252
Goodwill	Yes	Form 4797, part I and Form 6252

In 2023, Sebastian receives a \$100,000 down payment on the sale. A Form 6252 is required for each asset reported on the installment method. Sebastian must allocate the principal he receives each year to the assets according to their proportion of the selling price as shown in the following table.

Asset	Form 6252 Contract Price	Percentage of Total Sale of \$220,000	Allocation of Principal Received
Building	\$ 48,000	21.82%	\$21,818
Land	42,000	19.09%	19,091
Goodwill	18,500	8.41%	8,409
Total	\$108,500		

Each year, Sebastian multiplies the allocated principal by the gross profit percentage to determine the gain to report. The gross profit percentage for each asset equals the gross profit for that asset divided by the asset's contract price. The following table shows his gains reported in 2023 under the installment method.

Asset	Gross Profit	Gross Profit Percentage	2023 Principal	2023 Gain Reported
Building	\$ 9,600	20.00%	\$21,818	\$ 4,364
Land	24,900	59.29%	19,091	11,318
Goodwill	17,575	95.00%	8,409	7,989
Total	\$52,075			
Gross profit percentage of contract price		48.00%		

In 2023, Sebastian also reports the \$1,500 in profit from inventory on his Schedule C, *Profit or Loss From Business*, and depreciation recapture of \$5,209 (\$4,410 furnishings and equipment + \$799 truck) on his Form 4797. When he receives principal payments in later years, no part of the payment for the sale of these assets will be included in gross income.

REPORTING REQUIREMENT

If the sale of a business involves goodwill or going concern value, both the buyer and seller must report the allocation on Form 8594, *Asset Acquisition Statement under Section 1060*. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.⁷¹

Note. A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. However, the taxpayer treats any part of any gain or loss from unrealized receivables, inventory, and depreciation recapture as ordinary income. These parts of the gain cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method. For more information, see IRS Pub. 541, *Partnerships*. For corporate shareholders, a sale of shares may be treated as a sale of stock and reported under the installment method.

⁷¹ Instructions for Form 8594.

DISPOSITION OF AN INSTALLMENT OBLIGATION⁷²

When the taxpayer uses the installment method and later disposes of the installment obligation, the taxpayer generally has a gain or loss to report. A disposition includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation.⁷³

The tax treatment of the disposition of the installment agreement is based on the original sale of the property for which the taxpayer received the installment obligation. For example, if the original installment sale produced ordinary income, the disposition of the obligation results in ordinary income or loss. Likewise, if the original sale resulted in a capital gain, the disposition of the obligation results in a capital gain.

The following rules are used to calculate the gain or loss from the disposition of an installment obligation.

1. If the taxpayer sells or exchanges the obligation or the taxpayer accepts less than face value in satisfaction of the obligation, the gain or loss is the difference between the basis in the obligation and the amount the taxpayer realizes.
2. If the taxpayer disposes of the obligation in any other way, the gain or loss is the difference between the basis in the obligation and its FMV at the time of the disposition. This rule applies, for example, when the taxpayer gives the installment obligation to someone else or cancels the buyer's debt to the taxpayer.

The basis in an installment obligation is calculated using the following formula.

$$\text{Basis in installment obligation} = \text{Unpaid balance on obligation} \times (100\% - \text{Gross profit percentage})$$

Example 25. Ernie sold Olaf a building on contract for deed in 2019. The gross profit percentage on the sale was 60%. As of January 1, 2023, Olaf still owed Ernie \$10,000 on the contract. Ernie's basis in the obligation on January 1, 2023, is \$4,000 (\$10,000 unpaid balance $\times$ (100% – 60%).

TRANSFER BETWEEN SPOUSES OR FORMER SPOUSES

No gain or loss is recognized on the transfer of an installment obligation between spouses or former spouses when the transfer is incident to a divorce. A transfer is incident to a divorce if it occurs within one year after the date on which the marriage ends or is related to the end of the marriage.

The same tax treatment of the transferred obligation applies to the recipient of the transfer as would have applied to the taxpayer who made the transfer. The basis of the obligation to the transferee is the adjusted basis of the transferor. This nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

GIFTS⁷⁴

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

The IRS has not specified how to determine the FMV of the obligation at the time of the gift for these purposes. Determining an obligation's FMV requires knowing what the obligation could be sold for to an unrelated third party in an arm's-length transaction. Without a third party making an offer to buy the note, the FMV may not be readily available. In an open market, the FMV of an installment agreement is equal to the PV of the future cash flow using a discount rate that incorporates the debt instrument's underlying risk profile.⁷⁵

⁷² IRS Pub. 537, *Installment Sales*.

⁷³ IRC §453B(a)(2).

⁷⁴ Treas. Regs. §§25.2512-0 through 25.2512-8.

⁷⁵ *What is the Fair Market Value of Your Promissory Note?* Aug. 2009. Mercer Capital. [mercercapital.com/article/what-is-the-fair-market-value-of-your-promissory-note] Accessed on Aug. 14, 2024.

If the taxpayer is not able to determine the note's FMV by other means, the most conservative approach is to assume that the balance remaining on the note is the FMV of the note. This treatment is consistent with the principles of Temp. Treas. Reg. §15a.453-1T(d)(2), under which the FMV of the installment obligation is defined for purposes of electing out of the installment method.

Using those principles, the FMV of the installment agreement at the time of the gift is the FMV of the property sold minus any other consideration received. Other consideration includes principal previously reported. Using this approach, if the original transaction was conducted at arm's-length, the balance remaining on the note will be the FMV of the note. A taxpayer gifting the installment agreement would recognize a gain to the extent the remaining balance of the agreement exceeded the basis of the agreement.

Example 26. Use the same facts as **Example 25**. On January 1, 2023, Ernie gifts the installment contract to his daughter. The FMV of the obligation is the remaining \$10,000 due. Ernie's basis in the installment agreement is \$4,000. Ernie reports a \$6,000 gain on the disposition of the installment contract on his 2023 return.

Note. If the gift amount exceeds the annual exclusion, a gift tax return may be required. For more information on gift tax returns, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

CANCELATION

If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. The gain or loss is the difference between the taxpayer's basis in the obligation and its FMV at the time the taxpayer cancels it.

Example 27. Use the same facts as **Example 25**. In 2023, Olaf defaults on the agreement due to a series of unfortunate events that renders him insolvent. In addition, the real estate is declared an environmental hazard. Ernie decides that the costs of repossessing the property are prohibitive and the chances of collecting the balance of the obligation are nonexistent. Ernie cancels the remaining obligation.

Because the installment obligation is worthless at the time of cancellation, its FMV is zero. On his 2023 return, Ernie reports a loss from the cancellation equal to his remaining \$4,000 basis in the contract.

Note. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

FORGIVING PART OF THE BUYER'S DEBT

If a taxpayer accepts partial payment on the balance of the buyer's installment debt to the taxpayer and forgives the rest of the debt, the taxpayer treats the settlement as a disposition of the installment obligation. The gain or loss is the difference between the basis in the obligation and the amount the taxpayer realizes on the settlement.

TRANSACTIONS THAT ARE NOT DISPOSITIONS

When the taxpayer **reduces the selling price** but does not cancel the rest of the buyer's debt to the taxpayer, it is not considered a disposition of the installment obligation. The taxpayer must recalculate the gross profit percentage and apply it to the payments the taxpayer receives after the reduction (see the "Selling Price Reduced" section earlier).

When the **buyer of the property sells it** to someone else and the taxpayer agrees to let the new buyer assume the original buyer's installment obligation, the taxpayer has not disposed of the installment obligation. This is true even if the new buyer pays the taxpayer a higher rate of interest than the original buyer.

Death of the Seller

The **transfer of an installment obligation** (other than to a buyer) as a result of the **seller's death** is not a disposition.⁷⁶ The recipient of the debt obligation reports the installment payments in the same manner as the decedent would have if they had lived to receive the payments. The recipient does not receive a step up in basis in the installment obligation.

Example 28. In 2009, Patricia sold her business to her daughter, Peggy, on installment. When Patricia died, her son, Larry, inherited the installment note. Larry reports the interest and principal payments he receives each year in the same manner that Patricia would have if she had not passed away.

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, then **it is a disposition**. A transfer of the note under these conditions is considered to occur upon the earlier of the following events.⁷⁷

1. The executor's assent to the distribution of the note under state statute
2. The cancelation of the note by the executors
3. When the note becomes unenforceable
4. Termination of the administration of the estate for federal income tax purposes

The estate must calculate its gain or loss on the disposition based on the note's FMV. If the deceased holder and the buyer were related, the installment obligation's FMV is considered to be no less than its full face value.

Example 29. Use the same facts as **Example 28**, except Peggy inherits the note. Because Peggy is both related to the decedent and the obligor of the note, the FMV of the note is equal to the remaining principal due under the agreement. Accordingly, Patricia's estate must report the remaining unreported gain from the sale on its income tax return for the year the note is actually transferred to Peggy, the year the note is canceled by the executors, or the year the note becomes unenforceable.

REPOSSESSION⁷⁸

If the taxpayer repossesses the property after making an installment sale, the taxpayer must calculate the following.

- The gain (or loss) on the repossession
- The basis in the repossessed property

The rules for repossessions of personal property differ from those for real property. In addition, special rules apply if the taxpayer repossesses property that was their main home before the sale.⁷⁹

The repossession rules apply regardless of whether title to the property transfers to the buyer. It does not matter how the taxpayer repossesses the property, whether the taxpayer forecloses, or the buyer voluntarily surrenders the property to the taxpayer. However, the property is not considered repossessed when the buyer puts the property up for sale and the taxpayer repurchases it.

⁷⁶ IRC §453B(c).

⁷⁷ Ltr. Rul. 8552007 (Sep. 18, 1985).

⁷⁸ IRS Pub. 537, *Installment Sales*.

⁷⁹ See Treas. Reg. §1.1038-2 for further information.

For the repossession rules to apply, the repossession must at least partially satisfy the buyer's installment obligation to the taxpayer. The discharged obligation must be secured by the property the taxpayer repossesses. This requirement is met if the property is auctioned off after the taxpayer forecloses and the taxpayer then applies the installment obligation to the bid price at the auction.

FMV OF REPOSSESSED PROPERTY

The repossessed property's FMV is a question of fact to be established in each case. If the taxpayer bids for the property at a lawful public auction or judicial sale, its FMV is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

PERSONAL PROPERTY

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

The gain or loss on the repossession is calculated using the following formula.

$$\begin{array}{r} \text{FMV of property at time of repossession} \\ + \text{FMV of additional property received at time of repossession} \\ - \text{Total basis in the installment obligation} \\ - \text{Repossession expenses} \\ \hline \text{Gain or loss on repossession} \end{array}$$

How the taxpayer calculates the basis in the installment obligation depends on whether the taxpayer reported the original sale on the installment method. The method the taxpayer used to report the original sale also affects the character of the gain or loss on the repossession.

Installment Method Not Used to Report Original Sale

If the taxpayer did **not** use the installment method to report the original sale, the basis of the installment obligation is the value of the obligation used to calculate the gain or loss in the year of the sale less the principal payments received prior to repossession. Accordingly, the following formula may be used to calculate the gain or loss on the repossession.

$$\begin{array}{r} \text{FMV of property at time of repossession} \\ + \text{FMV of additional property received at time of repossession} \\ - \text{Value of the obligation used to calculate gain or loss in the year of the sale} \\ + \text{All principal payment received prior to repossession} \\ - \text{Repossession expenses} \\ \hline \text{Gain or loss on repossession} \end{array}$$

A gain on an installment obligation is taxed as ordinary income. If the repossession results in a loss, the loss is considered a bad debt. The manner in which the taxpayer deducts the bad debt depends on whether the taxpayer sold business or nonbusiness property in the original sale.

Note. See IRS Pub. 550, *Investment Income and Expenses*, for information on nonbusiness bad debts. See IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C)*, for information on business bad debts.

Example 30. Tommy sold his custom 1965 Volkswagen van to Marian for \$89,000 in 2019. On his 2019 return, Tommy elected out of the installment method. He reported the \$10,000 cash he received and the \$79,000 face value of the installment note as if he received the full \$89,000 in 2019. Tommy received \$9,000 principal payments, plus interest, in each year from 2020 to 2022.

In 2023, Marian's medical bills make it impossible for her to continue making the required payments, so she stops payments on the note. Tommy repossesses the van. Unfortunately, because Marian's glaucoma has interfered with her ability to drive, the van is only worth \$20,000 when Tommy takes it back. As part of the negotiated settlement, Marian also gives Tommy her porcelain doll collection, which has an FMV of \$25,000 at the time of the settlement. Tommy pays \$2,000 in attorney's fees to negotiate the settlement.

Tommy's loss on the repossession is calculated as follows. He reports the nonbusiness bad debt on his 2023 return as a as a short-term capital loss.

FMV of property at time of repossession	\$20,000
Plus: FMV of additional property received at time of repossession	25,000
Less: value of the obligation used to calculate gain or loss in the year of the sale	(79,000)
Plus: all principal payment received prior to repossession ($\$9,000 \times 3$)	27,000
Less: repossession expenses	(2,000)
Loss realized on repossession	(\$ 9,000)

Installment Method Used to Report Original Sale

If the taxpayer used the installment method to report the original sale, the basis in the installment obligation is the unpaid balance multiplied by the difference between 100% and the gross profit percentage. Accordingly, the gain or loss may be calculated using the following formula.

FMV of property at time of repossession
+ FMV of additional property received at time of repossession
– Unpaid balance on the obligation $\times$ (100% – gross profit percentage)
– Repossession expenses
Gain or loss on repossession

The gain or loss on the repossession is of the same character (capital or ordinary) as the gain on the original sale.

Example 31. Use the same facts as **Example 30**, except Tommy did not elect out of the installment method. On his 2019 return, he calculated his gross profit percentage to be 25%. The unpaid balance on the installment agreement at the time of the repossession is \$52,000 (\$79,000 installment note – (\$9,000 annual principal payments $\times$ 3 years)). Tommy's 2023 gain is calculated as follows.

FMV of property at time of repossession	\$20,000
Plus: FMV of additional property received at time of repossession	25,000
Less: Unpaid balance on the obligation of \$52,000 $\times$ (100% – 25% gross profit percentage)	(39,000)
Less: repossession expenses	(2,000)
Gain realized on repossession	\$ 4,000

REAL PROPERTY

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

As a result, the total payments the taxpayer received from the buyer on the original sale are considered income to the taxpayer. The taxpayer must report as gain on the repossession any part of the payments not yet included in income. These payments are amounts the taxpayer previously treated as a return of the adjusted basis and excluded from income. However, the total gain the taxpayer reports is limited, as explained later.

The rules concerning basis and gain on repossessed real property apply regardless of whether the taxpayer reported the sale on the installment method. However, they only apply if **all** the following conditions are met.

1. The repossession must occur to protect the taxpayer's security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. The taxpayer cannot pay any additional consideration to the buyer to get the property back unless either of the following situations applies.
 - a. The reacquisition and payment of the additional consideration were provided for in the original contract of sale.
 - b. The buyer defaulted, or default is imminent.

Additional consideration includes money and other property the taxpayer pays or transfers to the buyer. For example, additional consideration is paid when the taxpayer reacquires the property subject to a debt that arose after the original sale.

If any of the three conditions above are not met, then the taxpayer must use the rules applicable to personal property instead of real property.

Gain on Repossession

The gain on repossession of real property is the difference between the following amounts.

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

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

- The gain on the sale the taxpayer reported as income before the repossession
- The repossession costs

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

If the taxpayer reported the sale on the installment method, the taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if the taxpayer did not report the sale on the installment method, the gain is ordinary income.

Example 32. Gloria sold a tract of land in January 2021 for \$25,000. She received a \$5,000 down payment, plus a \$20,000 mortgage secured by the property and payable at the rate of \$4,000 annually, plus 5% interest. The payments began on January 1, 2022. The adjusted basis in the property was \$19,000, and she reported the transaction as an installment sale. The selling expenses were \$1,000. On her 2021 return, she calculated the gross profit as follows.

Selling price	\$25,000
Less: adjusted basis	(19,000)
Less: selling expenses	<u>(1,000)</u>
Gross profit	\$ 5,000

The gross profit percentage is 20% (\$5,000 gross profit ÷ \$25,000 contract price).

In 2021, Gloria included \$1,000 in income (20% × \$5,000 down payment). In 2022, she reported a profit of \$800 (20% × \$4,000 annual installment). In 2023, the buyer defaults and Gloria repossesses the property. She pays \$500 in legal fees to get the property back.

Gloria includes \$2,700 as taxable gain from the repossession on her 2023 return. Her original profit limited her taxable gain, which is calculated as follows.

Total payments received before repossession (\$5,000 + \$4,000)	\$9,000
Less: gain already reported as income (\$1,000 + \$800)	<u>(1,800)</u>
Gain on repossession	\$7,200
Gross profit on original sale	\$5,000
Less: gain already reported as income (\$1,000 + \$800)	(1,800)
Less: costs of repossession	<u>(500)</u>
Limit on taxable gain on repossession	\$2,700

The lesser of the limit on gain on repossession or the taxable gain is \$2,700.

Basis in Repossessed Property

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

- The adjusted basis in the installment obligation (i.e., the unpaid balance on the obligation × (100% – gross profit percentage))
- The repossession costs
- The taxable gain on the repossession

Example 33. Use the same facts as **Example 32**. The unpaid balance of the installment obligation (the \$20,000 note) is \$16,000 at the time of repossession (\$20,000 – 4,000 payment in 2022). The gross profit percentage on the original sale is 20%. Gloria's adjusted basis in the note is \$12,800 (\$16,000 × (100% – 20%)) at the time of the repossession. She calculates the basis in the repossessed property as follows.

Adjusted basis in the installment obligation	\$12,800
Plus: repossession costs	500
Plus: taxable gain on the repossession	<u>2,700</u>
Basis in repossessed real property	\$16,000

Holding Period for Resales

If the taxpayer resells the repossessed property, the resale may result in a capital gain or loss. The holding period includes the period the taxpayer owned the property **before the original sale** plus the **period after the repossession**. It does not include the period the buyer owned the property. If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad Debt

If the taxpayer repossesses real property under these rules, the taxpayer cannot take a bad debt deduction for any part of the buyer's installment obligation. This is true regardless of whether the obligation is fully satisfied by the repossession.

If the taxpayer took a bad debt deduction before the tax year of repossession, the taxpayer is considered to have recovered the bad debt when they repossessed the property. The taxpayer must report the bad debt deduction taken in the earlier year as income in the year of repossession. However, if any part of the earlier deduction did not reduce the tax, the taxpayer does not have to report that portion as income. The taxpayer increases the adjusted basis in the installment obligation by the amount the taxpayer reports as income from recovering the bad debt.

INTEREST ON DEFERRED TAX⁸⁰

Generally, the taxpayer must pay interest on the deferred tax related to any obligation that arises during a tax year from the disposition of property under the installment method if **both** of the following apply.

- The property had a sales price over \$150,000. In determining the sales price, all sales that are part of the same transaction are treated as a single sale.
- The total balance of all nondealer installment obligations arising during, and outstanding at the close of, the tax year is **more than \$5 million**.

The taxpayer must continue to pay this interest in subsequent years if installment obligations that originally required interest to be paid are still outstanding at the close of a tax year.

This interest rule does not apply to dispositions of the following types of property.

- Farm property
- Personal-use property by an individual
- Personal property sold before 1989
- Real property sold before 1988

Note. For more information about the interest on deferred tax and how to report the interest on tax returns, see IRS Pub. 537, *Installment Sales*.

⁸⁰ IRS Pub. 537, *Installment Sales*.

SELF-CANCELING INSTALLMENT NOTES

A self-canceling installment note (SCIN) instantly cancels all future payments due when the holder of the note dies.⁸¹ One purpose of a SCIN is to reduce the taxpayer's taxable estate without incurring gift taxes during the taxpayer's lifetime. A SCIN may also be part of a business succession plan.

Example 34. Jean has no children and no other family members who have an interest or ability to operate her business. Jean wants to retire, but she does not want to sell her tax practice to anyone incompetent or unethical. The only potential buyer that she trusts is her assistant, Tate.

Jean would give Tate the business outright, but she needs the income for support during her lifetime. Therefore, Jean sells the business at FMV to Tate on an installment contract that provides her the requisite annual income. However, because Tate is her chosen successor, the terms of the note provide that any balance on the installment contract will be forgiven upon her death.

Because the business was purchased at FMV, Jean does not have to file a gift tax return. Furthermore, the business is no longer part of her estate, so any future growth in its value will not be reflected in her estate's taxable value. The note has no value upon her death, so it is also not included in her estate.

CCA 201330033 outlines the IRS's position on SCINs. Based on that advisory, the preceding **Example 34** provides the "cleanest" fact pattern for passing IRS scrutiny.

1. The parties are not related, which makes it more likely to be an arm's-length transaction.
2. The cash flow from the note is appropriate to the situation because it is based on Jean's needs; therefore, there was a good reason, other than estate tax savings, to enter into the transaction.
3. The self-canceling feature will contribute to the business's odds of survival.

Based on these factors, it is easy to conclude that the transaction is a bona-fide sale and that tax avoidance is not its primary purpose. However, this type of situation is rare. The typical SCIN transactions involve related parties and multiple entities, such as revocable and irrevocable trusts. These complex transactions often employ many other features meant to preserve the tax benefits in the event of IRS scrutiny. Such intricacies are beyond the scope of this material.

Note. For background information on SCINs and a prelude to understanding the current climate, see "Self-Canceling Installment Notes (SCINs) – IRS Guidance and Pending Tax Court Case; CCA 201330033 and *Estate of William Davidson*" by Steve R. Akers. This article can be found at **uofi.tax/17b1x1** [www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Self-Canceling%20Installment%20Notes%20CCA%20201330033_10.18.13_FINAL.pdf].

The courts, not the IRS, have the ultimate authority to determine which fact patterns satisfy the requirements of the applicable tax laws and which do not. There have been a number of court cases involving SCINs.

⁸¹ CCA 201330033 (Feb. 24, 2012).

Two high-profile cases illustrate how the courts could address these issues — *Estate of Woelbing v. Comm’r*⁸² and *Estate of Davidson v. Comm’r*.⁸³ In these cases, the plaintiffs filed petitions with the Tax Court after the IRS assessed deficiencies. The IRS’s position was based on the following arguments.

1. The notes had no value at the time of the transactions; therefore, gift tax was due on the transfers.
2. The sales were not bona-fide arm’s-length transactions; therefore, the transferred assets should be included in the taxable estate.

Many interested parties hoped that the courts would weigh in on key issues, such as the following.

1. Which of the following measures are appropriate to use in determining the FMV of the note?⁸⁴
 - a. The rules applicable to installment debt instruments (the willing-buyer, willing-seller standard in Treas. Reg. §25.2512-8)
 - b. The rules applicable to annuities under IRC §7520
2. What is the effectiveness of certain provisions, such as the “value adjustment clause,” which were included in the SCIN documents to protect the transactions from being nullified by the IRS and the courts?⁸⁵

Unfortunately, these cases were settled out of court, leaving observers to continue speculating on the issues. The *Woelbing* case settlement involved no additional gift or estate tax liabilities. However, compromises may have been reached in a related situation.⁸⁶ Therefore, any conclusions drawn from the settlement are speculative.

Note. For the *Estate of Marion Woelbing* case, a stipulated decision was entered on March 28, 2016, indicating that no additional gift tax is due related to the SCIN transaction in this and the related *Estate of Donald Woelbing* case. However, this case did not address estate tax. The statute of limitations was still open for the decedent’s estate tax at the time of the settlement. Accordingly, the SCIN issues may have been part of undisclosed negotiations between the IRS and the decedent’s estate regarding unassessed estate taxes.⁸⁷

The *Davidson* case, in contrast, was settled for \$338 million, which covered estate and gift tax liabilities. While the settlement does not disclose how the valuation issues were decided, it does provide a warning to practitioners on the riskiness of using SCINs as part of “cutting-edge” estate planning strategies. After settling with the IRS, the estate sued Deloitte Tax, LLP. The case was dismissed because of a clause in the engagement agreement that limited the time frame during which the client could sue for malpractice.⁸⁸

⁸² *Estate of Donald Woelbing v. Comm’r*, Tax Court Docket No. 30261-13 (Petition filed Dec. 26, 2013; stipulated decision Mar. 25, 2016).

⁸³ *Estate of William Davidson v. Comm’r*, Tax Court Docket No. 13748-13 (Petition filed Jun. 14, 2013; stipulated decision Jul. 6, 2015).

⁸⁴ Ron Aucutt’s “Top Ten” *Estate Planning and Estate Tax Developments of 2015*. Aucutt, Ronald. Jan. 8, 2016. The American College of Trust and Estate Counsel. [www.actec.org/capital-letter/top-ten-estate-planning-and-estate-tax-developments-of-2015] Accessed on Jun. 7, 2024.

⁸⁵ Ibid.; *IRS Grabs \$388 Million From Billionaire Davidson Estate*. Ebeling, Ashlea. Jul. 8, 2015. Forbes. [www.forbes.com/sites/ashleaebeling/2015/07/08/irs-grabs-388-million-from-billionaire-davidson-estate] Accessed on Jun. 7, 2024.

⁸⁶ *Estate of Marion Woelbing v. Comm’r*, Tax Court Docket No. 30260-13. See *Settlement of Woelbing Cases (Involving Sale to Grantor Trust with Defined Value Feature)*. Akers, Steve. Apr. 2016. Bessemer Trust. [www.bessemertrust.com/insights/settlement-of-woelbing-cases-involving-sale-to-grantor-trust-with-defined-value-feature] Accessed on Jun. 7, 2024.

⁸⁷ *Expert Analysis: IRS Settlement With Carmex Owners Is Surprising*. Aucutt, Ronald D. Apr. 14, 2016. Law 360. [www.law360.com/articles/783013?scroll=1] Accessed on Jun. 7, 2024.

⁸⁸ *Protecting Yourself When Planning in Unsettled Waters: A Case Study on How to Structure Your Client Relationship to Protect Yourself from Malpractice Claims and Ethical Issues*. Snyder, Shawn. Jan. 25, 2018. Denver Estate Planning Council. [www.denverestateplanningcouncil.org/assets/Councils/Denver-CO/library/012518%20Handout.pdf] Accessed on Jun. 7, 2024.

GIFT TAX⁸⁹

The transfer of property by gift is subject to gift tax.⁹⁰ A transfer involves a gift if the transferor receives less than adequate consideration in exchange for the property.⁹¹ The gifted portion of a transfer is the amount by which the FMV of the property given exceeds the FMV of the consideration received.

Example 35. Aaron gave Margret a Triumph motorcycle in exchange for an antique teddy bear. The FMV of the Triumph was \$20,000. The FMV of the teddy bear was \$1,000. Aaron gave Margret a gift of \$19,000.

In general, a transaction in which property is exchanged for a promissory note is not treated as a gift if the value of the property transferred is substantially equal to the value of the note.⁹² The FMV of a note is presumed to be the amount of unpaid principal, plus accrued interest.⁹³ However, the note's face value and time period over which payments are due must be reasonable in light of the circumstances.

A note's FMV is worth less than its unpaid principal, plus interest, in the following circumstances.

1. The interest rate, maturity date, or other factors cause it to be worth less.
2. The full face value of the note is not collectible (due to the insolvency of the liable parties or for other reasons).
3. The FMV of the property pledged as security is insufficient to satisfy the debt.

Example 36. Elvis gives his mother a Cadillac in exchange for an unsecured note payable. The FMV of the Cadillac is \$20,000. The note payable is for \$20,000. However, under the terms of the note, the principal is due in 500 years and the interest rate is 0%. Elvis gives his mother a gift of \$20,000.

In *Estate of Costanza v. Comm'r*,⁹⁴ the appellate court set the standard for related party SCINs: **“a SCIN signed by family members is presumed to be a gift and not a bona fide transaction.”** However, the appellate court also stated that this presumption may be rebutted by affirmative evidence that at the time of the transaction there was a real expectation of repayment and intent to enforce the collection of the indebtedness.

ESTATE TAX⁹⁵

The FMV of a decedent's gross estate is subject to the estate tax. An estate includes the FMV of all property owned by the decedent at the time of their death, to the extent of the decedent's ownership interest in the property.⁹⁶ An estate also includes the value of **transferred** property in the following circumstances.⁹⁷

1. The enjoyment of the property was under the decedent's control at the time of their death (in a grantor trust or otherwise). “Under the decedent's control” includes situations in which the control was shared with another party or parties.
2. During the 3-year period ending on the date of the decedent's death, the decedent surrendered the property or the rights to control the property for less than adequate consideration.

⁸⁹. CCA 201330033 (Feb. 24, 2012).

⁹⁰. IRC §2501.

⁹¹. IRC §2512(b).

⁹². Treas. Reg. §25.2512-8.

⁹³. Treas. Reg. §25.2512-4.

⁹⁴. *Estate of Costanza v. Comm'r*, 320 F.3d 595 (6th Cir. 2003), *rev'g* TC Memo 2001-128.

⁹⁵. CCA 201330033 (Feb. 24, 2012).

⁹⁶. IRC §2033.

⁹⁷. IRC §2038.

Example 37. On his deathbed, Carl gave his mansion to Priscilla in exchange for a SCIN. The mansion was included in his estate because he clearly made the transfer in anticipation of his death without any intention that the SCIN would require any payments from Priscilla.

If a SCIN is not a valid debt instrument, the decedent may be considered to have retained enough control over the assets to include them in the decedent's estate. One significant factor in determining if a SCIN is a valid debt instrument is the debtor's ability to repay the note.

INCOME TAX

There are particular income tax consequences to canceling a note when the debt is between related parties. In such a case, the holder of the note must recognize income equal to the difference between the greater of the FMV or the **face** value of the note and the holder's basis in the obligation.⁹⁸ This also applies when the holder of the note is an estate.⁹⁹ The estate's basis in the note is not stepped up because the unpaid principal is income in respect of a decedent (IRD); the estate's basis is equal to the decedent's basis.¹⁰⁰

The IRS's position is that the IRD related to the canceled note principal is reported on the estate's initial income tax return.¹⁰¹ This position was upheld by the 8th Circuit Court in *Estate of Frane v. Comm'r*¹⁰² in 1993.

Observation. It may be argued that the position taken by the dissenting justices in *Estate of Frane v. Comm'r* is the most legally sound.¹⁰³ In that dissent, the judge recharacterizes the transaction as a contingent payment sale. If a SCIN arrangement is a contingent payment sale, the life span of the decedent determines the selling price of the property. There is no debt canceled and there is no IRD to recognize. Practitioners taking such a stance are advised to disclose that the position is contrary to IRS published guidance.

It is unclear what the income tax consequences are of a SCIN's cancellation feature for the purchaser of the property. Exploring the following questions is outside the scope of this material, but the issues should be researched by anyone representing a client who has received property via a SCIN arrangement.

1. What is the purchaser's basis in the property? It may be equal to the principal payments actually made if SCINs are considered contingent payment instruments under Treas. Regs. §§1.483-4 and 1.1275-4(c)(5).
2. Are there cancellation-of-indebtedness issues under IRC §108(e)?

^{98.} IRC §§453B(a) and (f).

^{99.} IRC §§691(a)(2), (4), and (5).

^{100.} IRC §691(a)(4).

^{101.} Rev. Rul. 86-72, 1986-1 CB 253.

^{102.} *Estate of Frane v. Comm'r*, 998 F.2d 567 (1993), *aff'g* 98 TC 341 (1992).

^{103.} *Ibid.*

TEST RATES FOR UNSTATED INTEREST AND ORIGINAL ISSUE DISCOUNT¹⁰⁴

An installment sale contract may provide that each deferred payment on the sale includes interest or that there will be an interest payment in addition to the principal payment. Interest provided under the contract is referred to as **stated interest**.

If an installment sale contract does not provide for **adequate** stated interest, part of the stated principal amount of the contract may be recharacterized as interest. When IRC §483 applies to the contract, this interest is called **unstated interest**. When IRC §1274 applies to the contract, this interest is called **OID**. Whether either of these sections applies to a particular installment sale contract depends on several factors, including the total selling price and the type of property sold. An installment sale contract does not provide for adequate stated interest if the stated interest rate is lower than the test rate (both of these Code sections and the test rate are discussed later).

To determine whether §§1274 or 483 applies to an installment sale contract, all sales or exchanges that are part of the same transaction (or related transactions) are treated as a single sale or exchange. In addition, all contracts arising from the same transaction (or a series of related transactions) are treated as a single contract. The total consideration due under an installment sale contract is determined at the time of the sale or exchange. Any payment (other than a debt instrument) is taken into account at its FMV.

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

Note. The buyer reduces their basis in the assets by the unstated interest or OID. Their interest expense includes the unstated interest and/or OID. These rules do not apply to personal-use property.

IRC §§483 and 1274

IRC §§483 and 1274 both require that when the stated interest rate in an installment agreement is not adequate, the seller and the buyer must recharacterize a portion of the contract principal as interest. The reason it is important to know which Code section applies is because **unstated interest (§483)** is included in income based on the taxpayer's method of accounting and **OID (§1274)** is included in income over the term of the contract. The following example demonstrates how the interest is taxed under each of these Code sections.

Example 38. Rocky has an installment contract that calls for one payment of \$500,000 five years following the agreement date. The agreement states that the interest rate is 0%. If the AFR is 2%, the PV of the contract is \$452,865.¹⁰⁵ Accordingly, the imputed interest over the life of the contract is \$47,135 (\$500,000 payment – \$452,865 PV).

If the contract falls under §483 and Rocky uses the cash basis of accounting, he will include the \$47,135 interest in income in the year the payment is received. If the contract falls under §1274, he must recognize the interest income each year as it accrues regardless of his method of accounting.

¹⁰⁴. IRS Pub. 537, *Installment Sales*.

¹⁰⁵. Calculated using *Present Value Calculator*. Financial Mentor. [financialmentor.com/calculator/present-value-calculator] Accessed on Jun. 1, 2024.

OID includable in income each year is based on the constant yield method described in IRC §1272 (this computation is beyond the scope of this chapter). In some cases, the OID on an installment sale contract may also include all or part of the stated interest, especially if the stated interest is not paid at least annually. Each Code provision exempts a number of transactions. Before determining whether the interest rate is adequate, it is important to ensure the transaction does not qualify for one of the exceptions applicable to both Code sections. **Both** §§483 and 1274 **exclude** debt instruments related to sales and exchanges under the following circumstances.

- All payments are due within six months after the date of the sale.
- The buyer assumes an existing debt on the exchanged property unless the terms or conditions of the debt instrument are modified in a manner that constitutes a deemed exchange under Treas. Reg. §1.1001-3.
- Either the debt instrument issued or the exchanged property is publicly traded.
- The sale or exchange involves all of the substantial rights to a patent, or an undivided interest in property that includes part or all substantial rights to a patent, or if any amount is contingent on the productivity, use, or disposition of the property transferred.¹⁰⁶
- An annuity contract described in IRC §1275(a)(1)(B) and Treas. Reg. §1.1275-1(j) is issued as part of the exchange.
- The property is transferred between spouses or incident to a divorce.¹⁰⁷
- A demand loan that is a below-market loan described in IRC §7872(c)(1) (e.g., gift loans and corporation-shareholder loans) is issued as part of the exchange.
- A below-market loan described in §7872(c)(1) (which applies only to the seller) is issued in connection with the sale or exchange of personal-use property. The exchanged property is personal-use property in the hands of the buyer.¹⁰⁸

If both §§483 and 1274 apply to a transaction, then the rules of §1274 apply.¹⁰⁹ Thus, practitioners should first review the exceptions for §1274. Generally, §1274 applies to a debt instrument issued for the sale or exchange of property when **both** of the following conditions exist.

1. Any payment is due more than six months after the date of the sale or exchange.
2. The note does not provide for adequate stated interest.

¹⁰⁶. See IRS Pub. 544, *Sales and Other Dispositions of Assets*.

¹⁰⁷. See IRC §1041.

¹⁰⁸. IRC §1275(b).

¹⁰⁹. IRC §483(d)(1).

However, a number of exceptions apply in addition to those previously covered that apply to both Code sections. The first exception is for cash method debt instruments issued as part of property exchanges that do not involve new tangible personal property subject to depreciation.¹¹⁰ A **cash method debt instrument** is any debt instrument given as payment for a sale or exchange if the debt's stated principal is \$5,070,500¹¹¹ (in 2024) **or less** and the following conditions apply (this stated principal amount is indexed annually for inflation).¹¹²

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

IRC §1274 also does **not** apply to an installment sale contract that is a cash method debt instrument arising from the following types of sales and exchanges.

1. Total payments are \$250,000 or less
2. Sale or exchange of the taxpayer's main home
3. Farms sold or exchanged for \$1 million or less by an individual, an estate, a testamentary trust, an IRC §1244(c) small business corporation, or a domestic partnership that meets requirements similar to those of §1244(c)(3)
4. Certain land transfers between related persons (discussed later)

If an installment contract lacks adequate stated interest and meets one of the preceding §1274 exceptions, the rules of §483 must be used. However, there are additional exceptions to the application of §483. IRC §483 does **not** apply to an installment sale contract that arises from the following transactions.

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

Note. If the debt is subject to the §483 rules and is also subject to the below-market loan rules, the below-market loan rules apply. Below-market loans include gift loans, compensation-related loans, and corporation-shareholder loans. For more information, see the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Investments. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹¹⁰ IRC §1274A(b) defines the excluded property as “other than new section 38 property within the meaning of section 48(b), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990...”

¹¹¹ Rev. Proc. 2023-34, 2023-48 IRB 1287.

¹¹² IRC §1274A(d)(2)(A).

Adequate Stated Interest Test Rate

In general, an installment sale contract provides for adequate stated interest if the stated interest rate (based on an appropriate compounding period) is at least equal to the test rate of interest. The test rate of interest for a contract is the “3-month rate.” The 3-month rate is the **lower** of the following AFRs based on the appropriate compounding period (this 3-month rate is **not** the same as the 3-month rate used to calculate imputed interest).

1. The lowest AFR in effect during the 3-month period ending with the first month in which there is a **binding written contract** that substantially provides the terms under which the sale or exchange is ultimately completed.
2. The lowest AFR in effect during the 3-month period ending with the month in which **the sale or exchange occurs**.

Note. AFRs are published monthly by the IRS and can be found at **uofi.tax/24x6x1** [apps.irs.gov/app/picklist/list/federalRates.html].

Example 39. On June 1, 2023, Archie entered into a binding written contract to sell his tavern. The contract called for the transfer of the property on contract for deed to the buyer on March 1, 2024. To determine if the contract for deed included adequate stated interest, his CPA used the lowest appropriate 3-month rate for April, May, and June of 2023 and January, February, and March of 2024.

For 2024, if the sale or exchange involves seller financing of \$7,098,600¹¹³ **or less**, the test rate of interest cannot be more than 9%, compounded semiannually. However, if the sale or exchange is over \$7,098,600 or for new IRC §38 property, the test rate of interest is 100% of the AFR. For information on new IRC §38 property, see IRC §48(b), as in effect before the enactment of the Omnibus Budget Reconciliation Act of 1990.

Test Rate for Land Transfers Between Related Persons

For land transfers between related persons, the test rate used to determine if the interest rate is adequate cannot exceed 6%, compounded semiannually.¹¹⁴ Related persons for this purpose include an individual and the members of the individual’s family and their spouses. Members of an individual’s family include the individual’s spouse, brothers and sisters (whole or half), ancestors, and lineal descendants.

The §483 rules apply to debt instruments issued in a land sale between related persons to the extent the sum of the following amounts is **\$500,000 or less**.

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

The §1274 rules, if otherwise applicable, apply to debt instruments issued in a sale of land between related parties to the extent the stated principal amount **exceeds** \$500,000. IRC §1274 is also used instead of §483 if any party to the sale is a nonresident alien.

¹¹³. Rev. Proc. 2023-34, 2023-48 IRB 1287.

¹¹⁴. IRC §483(e)(1).