INSTALLMENT SALE REPORTING CAN WORK FOR YOU TAX WISE

By Martin H. Abo, CPA/AB/CVA/CFF October 16, 2015

Do you own a property that has appreciated considerably and that you want to sell, perhaps to free up some capital, perhaps to downsize your operation, perhaps to expand but now rent rather than own? Are you concerned about incurring a large capital gains tax liability? One option is to structure the sale as an installment sale.

Of course, selling commercial real estate in a slow or problematic market, you will often be requested anyway to provide financing to ensure the deal gets consummated. Where at least one payment is received after the tax year in which the sale occurs, the installment sale method is used to defer a portion of the income tax due on a gain. In fact, unless you specifically elect out, the installment sale method is mandated by the Internal Revenue Service.

Under the installment sale method, the seller recognizes a portion of each payment as gain when received. Typically, each payment the seller receives consists of three parts: (1) a return of basis (investment) in the property sold, (2) gain (profit) on the sale, and (3) interest on the installment note. Only the gain and interest portions of each payment are taxable to the seller.

Reporting gain from the disposition of property under the installment sale method allows the seller to spread the tax liability over several years rather than all in the year of sale. Thus, the seller's payment of tax corresponds with the actual cash flow generated from the sale.

Of course, a number of limitations and restrictions come with the use of the installment sale method. In general, persons who regularly sell or otherwise dispose of personal property on the installment plan or who hold real property for sale to customers in the ordinary course of business ("dealers") generally cannot use the installment sale method except for sales of timeshares, residential lots or farm property. However, in the case of timeshares and residential lots, interest must be computed and paid each year on the deferred tax liability. Also, any item that must be included in ending inventory is ineligible for such installment sale reporting.

We are CPAs and business advisors and NOT attorneys but sellers who decide on this strategy are cautioned that an installment sale carries more risk than an outright sale of the property. Rather obvious suggestions to keep such risk manageable include:

- Carefully assessing the buyer's creditworthiness. Consider getting personal guarantees.
- Evaluate the future income producing capability of the property to make sure it provides sufficient cash flow to enable the buyer to make the payments.
- Use an interest rate that is competitive with current market rates in the area so as not to squash the deal.
- Obtain a down payment of at least 20% to have a cushion in the event of buyer default, and to cover the expenses if foreclosure becomes necessary.

In certain circumstances, it may be beneficial to elect out of the installment sale method and report the entire gain in the year of sale. When you or your business has expiring carryovers such as net operating losses, tax credits, or perhaps

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charitable contributions, opting OUT OF reporting the entire gain in the year of sale could allow use of those carryovers and minimize any tax liability. In addition, if you are concerned that applicable tax rates will increase in the future, it may be advantageous to elect out of installment sale treatment and avoid higher taxes down the road.

Business property transactions are often complex, and surrounding yourself with a credible "team" made up of your CPA, attorney and real estate professional can be vital in developing strategies that make it possible to bring a contemplated transaction to a successful conclusion.

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