The Two-Year Installment Sale

By Robert S. Keebler, CPA?PFS, MST, AEP (Distinguished), CGMA

From 2003 to 2012, the long-term capital gains rate was 5% for taxpayers in the two lowest ordinary income tax brackets and 15% for all other taxpayers. The American Taxpayer Relief Act of 2012 (ATRA) added new progressivity to the tax rates, setting the long-term capital gains rate at 0% for the 10% and 15% ordinary income tax brackets, 15% for the 25% and 35% ordinary income brackets and 20% for the 39.6% ordinary income tax bracket. This progressivity greatly increases the importance of spreading out large long-term capital gains to avoid being taxed in a higher bracket.

The easiest way to smooth out capital gain income is by making an installment sale, but an installment sale has an important downside. The sale spreads out income recognition over a number of years, but produces a corresponding delay in receiving payments. It would be much more favorable if the seller (or the seller's family) could receive the full amount of the sale proceeds currently and reinvest it, but defer the tax payable over a number of years.

Two-Year Installment Sale Strategy

Prior to 1980, taxpayers could achieve this favorable timing mismatch. The following example shows how the strategy worked.

Example 1.

- Parent (P) owns Blackacre, an investment property with a basis of $200,000 and a fair market value of $1,000,000
- P sells Blackacre to a non-grantor trust (T) for the benefit of P's children in exchange for a 10-year installment note

- T receives a stepped-up basis of $1,000,000 for Blackacre
- As soon as possible after the first sale, T sells Blackacre to an unrelated taxpayer (U) for cash
- Assume that the value of Blackacre has not changed between the two sale dates and is still $1,000,000
- T (and P's family) receive the full $1,000,000 value of Blackacre and can reinvest it before any tax is paid on the $800,000 gain
- The gain is spread over a 10-year period, with $80,000 being recognized on each installment payment

Congressional Response

Congress partially blocked this strategy in 1980 by enacting

IRC § 453(e). This section basically provides that:

- If any person sells property to a related person, and
- Before the person making the first sale receives all payments, the related person sells the property,
- Then, the amount received on the second sale is treated as received by the first seller at the time of the second sale

The term "related persons" covers the same persons and entities as the attribution rules of IRC §§ 318 and 267(b). Thus, it includes the original seller's spouse, siblings, lineal descendants and ancestors and certain partnerships, trusts, estates and corporations (IRC § 453(f)(1)). Finally, § 453(e) doesn't apply if the taxpayer can show to the satisfaction of the IRS that neither the first sale nor the second sale had as one of its principal purposes the avoidance of federal income tax (IRC § 453(e)(7).

> *Example 2.* Assume the same facts as in *Example 1* except that the sale is after 1980 and IRC § 453(e) applies. When T sells Blackacre to U, P is treated as receiving the $1,000,000 paid by U to T and recognizes a capital gain of $800,000 at that time.

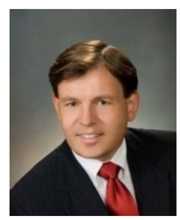
Continuing Tax Planning Opportunity

The legislation left open an important planning opportunity, however. Except in the case of marketable securities, IRC § 453 (e) only applies if the date of the second disposition is no more than two years from the date of the first disposition (IRC § 453(e)(2)(A)). The running of the two-year period is suspended, however, for any period during which the related person's risk of loss is substantially diminished by the holding a put with respect to the purchased property, the holding by another person of the right to purchase the property or by a short sale or any other transaction (IRC § 453(e)(2)(B)).

This means that much of the economic benefit of the timing mismatch between receipt of income and recognition of gain can still be exploited if the original buyer is willing to hold the purchased property for more than two years before selling it without taking steps to limits its risk.

Example 3. Assume the same facts as in *Example 1* above except that the transaction is structured to avoid application of IRC § 453(e). T makes two payments of $100,000 to P and P recognizes gain of $80,000 on each payment. After the second payment is made, T sells Blackacre to U. Assume that the value of Blackacre has increased to $1,100,000 at this time. T recognizes a gain of $100,000 on the sale to U. The family has cashed in the full $1,100,000 of value in Blackacre while paying tax on only $300,000 of the $900,000 gain. T will continue to pay off the note over the next eight years, gaining a substantial timing advantage.

ABOUT THE AUTHOR:



Robert S. Keebler CPA/PFS, MST, AEP (Distinguished), CGMA is a partner with Keebler & Associates, LLP and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels and has been named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States. Mr. Keebler is the past Editor-in-Chief of CCH's magazine, Journal of Retirement Planning, and a member of CCH's Financial and Estate Planning Advisory Board. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and has received over 150 favorable private letter rulings. Mr. Keebler is nationally recognized as an expert in family wealth transfer and preservation planning, charitable giving, retirement distribution planning and estate administration and works collaboratively with other professionals on academic reviews and papers, as well as client matters. He can be reached at (920)593-1701 or at robert.keebler@keeblerandassociates.com.

Image courtesy of iosphere at FreeDigitalPhotos.net