PacificCPE

COURSE
30504A

Installment Sales: Rules and Reporting Requirements

Installment sales offer clients a way to spread income recognition over time—but the rules governing them require careful attention. Covering what qualifies as an installment sale, how to apply the general and special rules, and how to report these transactions properly, this course is a practical resource for tax professionals who encounter seller-financed deals, deferred payment arrangements, or property dispositions where proceeds arrive over multiple years. Clear and thorough, it helps ensure compliance and accurate reporting.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the general rules that apply to all installment sales, and the more complex rules that apply only when certain conditions exist or certain types of property are sold.

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Chapter 1: INSTALLMENT SALES

Chapter Objective

After completing this chapter, you should be able to:

- Identify the general rules that apply to all installment sales, and the more complex rules that apply only when certain conditions exist or certain types of property are sold.

I. REMINDERS

Reporting form for Qualified Opportunity Fund (QOF) investments. Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, is used to report holdings, deferred gains, and dispositions of QOF investments. See the Instructions for Form 8997 for more information.

Like-kind exchanges. Beginning after December 31, 2017, section 1031 like-kind exchange treatment applies only to exchanges of real property held for use in a trade or business or for investment, other than real property held primarily for sale. See Like-Kind Exchange, later.

II. INTRODUCTION

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you realize a gain on an installment sale, you may be able to report part of your gain when you receive each payment. This method of reporting gain is called the installment method. You cannot use the installment method to report a loss. You can choose to report all of your gain in the year of sale.

This chapter discusses the general rules that apply to all installment sales. It also discusses more complex rules that apply only when certain conditions exist or certain types of property are sold.

If you sell your home or other nonbusiness property under an installment plan, you may need to consider only the General Rules. If you sell business or rental property or have a like-kind exchange or other complex situation, see the appropriate discussion under Other Rules, later.

III. WHAT IS AN INSTALLMENT SALE

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. The rules for installment sales don’t apply if you elect not to use the installment method (see Electing Out of the Installment Method, later) or the transaction is one for which the installment method may not apply.

The installment sales method cannot be used for the following.

Sale of inventory. The regular sale of inventory of personal property does not qualify as an installment sale even if you receive a payment after the year of sale. See Sale of a Business, later.

Dealer sales. Sales of personal property by a person who regularly sells or otherwise disposes of the same type of personal property on the installment plan are not installment sales. This rule also applies to real property held for sale to customers in the ordinary course of a trade or business. However, the rule does not apply to an installment sale of property used or produced in farming. **Special rule.** Dealers of timeshares and residential lots can 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 section 453(l) of the Internal Revenue Code.

Stock or securities. You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain on the sale in the year in which the trade date falls. **Installment obligation.** The buyer’s obligation to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer’s debt to you.

IV. GENERAL RULES

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method.

See Electing Out of the Installment Method, later, for information on recognizing the entire gain in the year of sale.

Fair market value (FMV). This is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of all the necessary facts.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business or investment property, you can deduct it only in the tax year of sale.

Unstated interest and original issue discount. If your sale calls for payments in a later year and the sales contract provides for little or no interest, you may have to figure unstated interest or original issue discount (OID), even if you have a loss. See Unstated Interest and Original Issue Discount (OID), later.

FIGURING INSTALLMENT SALE INCOME

You can use the following discussions or Form 6252 to help you determine gross profit, contract price, gross profit percentage, and installment sale income.

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

- Interest income.
- Return of your adjusted basis in the property.
- Gain on the sale.

In each year you receive a payment, you must include in income both the interest part and the part that's your gain on the sale. You don't include in income the part that's the return of your basis in the property. Basis is the amount of your investment in the property for installment sale purposes. You may have interest income in years you do not receive a payment.

Interest Income

You must report interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it's not called interest in your agreement with the buyer. Interest provided in the agreement is called stated interest. If the agreement doesn't provide for enough stated interest, there may be unstated interest or original issue discount (OID). You may have to include interest in income even in a year you receive no payment, depending on your regular method of accounting and whether the interest is unstated interest or OID. See Unstated Interest and Original Issue Discount (OID), later.

Adjusted Basis and Installment Sale Income (Gain on Sale)

After you have determined how much of each payment to treat as interest, you treat the rest of each payment as if it were made up of two parts.

- A tax-free return of your adjusted basis in the property, and
- Your gain (referred to as installment sale income on Form 6252).

Figuring adjusted basis for installment sale purposes. You can use Worksheet 6-A to figure your adjusted basis in the property for installment sale purposes. When you have completed the worksheet, you will also have determined the gross profit percentage necessary to figure your installment sale income (gain) for this year.

WORKSHEET 6-A. FIGURING ADJUSTED BASIS AND GROSS PROFIT PERCENTAGE

1. Enter the selling price for the property.	_____
2. Enter your adjusted basis for the property.	_____
3. Enter your selling expenses.	_____
4. Enter any depreciation recapture.	_____
5. Add lines 2, 3, and 4. This is your adjusted basis for installment sale purposes.	_____
6. Subtract line 5 from line 1. If zero or less, enter -0-. This is your gross profit. If the amount entered on line 6 is zero, stop here. You cannot use the installment method.	_____
7. Enter the contract price for the property.	_____
8. Divide line 6 by line 7. This is your gross profit percentage.	_____

Selling price. The selling price is the total cost of the property to the buyer and includes any of the **following:**

- Any money you are to receive,
- The fair market value (FMV) of any property you are to receive (FMV is discussed under General Rules, earlier).
- Any existing mortgage or other debt the buyer pays, assumes, or takes (a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property), and
- Any of your selling expenses the buyer pays.

Do not include stated interest, unstated interest, any amount recomputed or recharacterized as interest, or original issue discount.

Adjusted basis for installment sale purposes. Your adjusted basis is the total of the following three items.

- Adjusted basis.
- Selling expenses.
- Depreciation recapture.

Adjusted basis. Basis is the amount of your investment in the property for tax purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of property you inherit, receive as a gift, build yourself, or receive in a tax-free exchange is figured differently.

While you own property, various events may change your original basis. Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as deductible casualty losses or depreciation previously allowed or allowable, decrease basis. The result is adjusted basis.

Selling expenses. Selling expenses relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property.

Depreciation recapture. If the property you sold was depreciable property, you may need to recapture part of the gain on the sale as ordinary income. See Depreciation Recapture Income, later.

Gross profit. Gross profit is the total gain you report on the installment method. To figure your gross profit, subtract your adjusted basis for installment sale purposes from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See Sale of your home, later.

Contract price. Contract price equals:

1. The selling price, minus
2. The mortgages, debts, and other liabilities assumed or taken by the buyer, plus
3. The amount by which the mortgages, debts, and other liabilities assumed or taken by the buyer exceed your adjusted basis for installment sale purposes.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as installment sale income. This percentage is called the gross profit percentage and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see the Example under Selling Price Reduced, later, for a situation where the gross profit percentage changes.

Example

You sell property at a contract price of $6,000 and your gross profit is $1,500. Your gross profit percentage is 25% ($1,500 ÷ $6,000). After subtracting interest, you report 25% of each payment, including the down payment, as installment sale income from the sale for the tax year you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.

Amount to report as installment sale income. Multiply the payments you receive each year (less interest) by the gross profit percentage. The result is your installment sale income for the tax year. In certain circumstances, you may be treated as having received a payment, even though you received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment. For a detailed discussion, see Payments Received or Considered Received, later.

Selling Price Reduced

If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. Refigure your gross profit using Worksheet 6-B, New Gross Profit Percentage – Selling Price Reduced. You will spread any remaining gain over future installments.

WORKSHEET 6-B. NEW GROSS PROFIT PERCENTAGE – SELLING PRICE REDUCED

1. Enter the reduced selling price for the property.		_____
2. Enter your adjusted basis for the property.	_____	
3. Enter your selling expenses.	_____	
4. Enter any depreciation recapture.	_____	
5. Add lines 2, 3, and 4.		_____
6. Subtract line 5 from line 1. This is your adjusted gross profit.		_____
7. Enter any installment sale income reported in prior year(s).		_____
8. Subtract line 7 from line 6.	_____	
9. Future installments.	_____	
10. Divide line 8 by line 9. This is your gross profit percentage.*		_____

*Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.

Example

In 2023, you sold land with a basis of $40,000 for $100,000. Your gross profit was $60,000. In 2023, you received a $20,000 down payment and the buyer's note for $80,000. The note provides for four annual payments of $20,000 each, plus 8% interest, beginning in 2024. Your gross profit percentage is 60%. You reported a gain of $12,000 on each payment received in 2023 and 2024.

In 2025, you and the buyer agreed to reduce the purchase price to $85,000 and payments during 2025, 2026, and 2027 are reduced to $15,000 for each year.

The new gross profit percentage, 46.67%, is figured on Example—Worksheet 6-B.

You will report a gain of $7,000 (46.67% of $15,000) on each of the $15,000 installments due in 2025, 2026, and 2027.

EXAMPLE - WORKSHEET 6-B. NEW GROSS PROFIT PERCENTAGE – SELLING PRICE REDUCED