

Abstract: Owners of real property, whether businesses or individuals, may not always be able to dispose of it as quickly as they'd like. One avenue for perhaps finding a buyer a little sooner is an installment sale. This article discusses the benefits, risks and methodology of these transactions.

Need to sell real property? Try an installment sale

If your company owns real property, or you do so individually, you may not always be able to dispose of it as quickly as you'd like. One avenue for perhaps finding a buyer a little sooner is an installment sale.

Benefits and risks

An installment sale occurs when you transfer property in exchange for a promissory note and receive at least one payment after the tax year of the sale. Doing so allows you to receive interest on the full amount of the promissory note, often at a higher rate than you could earn from other investments, while deferring taxes and improving cash flow.

But there may be some disadvantages for sellers. For instance, the buyer may not make all payments and you may have to deal with foreclosure.

Methodology

You generally must report an installment sale on your tax return under the "installment method." Each installment payment typically consists of interest income, return of your adjusted basis in the property and gain on the sale. For every taxable year in which you receive an installment payment, you must report as income the interest and gain components.

Calculating taxable gain involves multiplying the amount of payments, excluding interest, received in the taxable year by the gross profit ratio for the sale. The gross profit ratio is equal to the gross profit (the selling price less your adjusted basis) divided by the total contract price (the selling price less any qualifying indebtedness — mortgages, debts and other liabilities assumed or taken by the buyer — that doesn't exceed your basis).

The selling price includes the money and the fair market value of any other property you received for the sale of the property, selling expenses paid by the buyer and existing debt encumbering the property (regardless of whether the buyer assumes personal liability for it).

You may be considered to have received a taxable payment even if the buyer doesn't pay you directly. If the buyer assumes or pays any of your debts or expenses, it could be deemed a payment in the year of the sale. In many cases, though, the buyer's assumption of your debt is treated as a recovery of your basis, rather than a payment.

Complex rules

The rules of installment sales are complex. Please contact us to discuss this strategy further.