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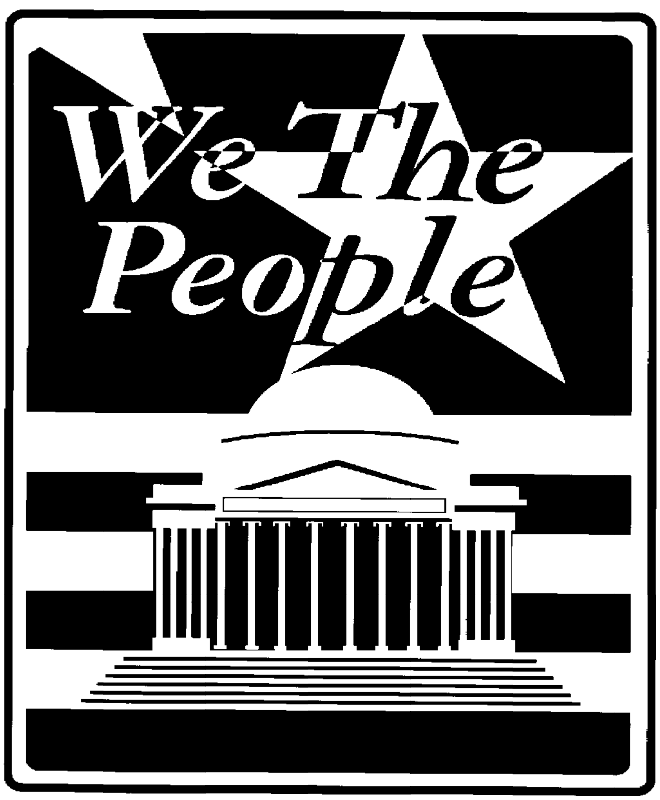
Installment Sales

For use in preparing

1994 Returns



Contents

Introduction

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

If you sold your home or other nonbusiness property, under an installment plan, you will need only the general rules. If you sold business or rental property for which you claimed depreciation deductions, see *Depreciation Recapture Income* under *Other Rules.*

If you sell your entire interest in a passive activity on the installment method, special rules apply to the treatment of passive activity losses. For more information, see Publication 925.

Useful Items

You may want to see:

Publication

- ❏ **523** Selling Your Home
- ❏ **534** Depreciation
- ❏ **535** Business Expenses
- ❏ **541** Tax Information on Partnerships
- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **550** Investment Income and Expenses
- ❏ **551** Basis of Assets
- ❏ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

- ❏ **6252** Installment Sale Income

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What is an Installment Sale?

An installment sale is a sale of property where one or more payments are received after the close of the tax year. However, the installment sale rules do not apply to the sale of inventory. See *Sale of a Business* under *Other Rules.*

If you finance the buyer's purchase of your own property, instead of having the buyer get a loan or mortgage, you probably have an installment sale. However, it is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.

If a sale qualifies as an installment sale, you must report it on the installment method unless you elect to recognize gain on the sale under your regular method of accounting. See *Electing Out* under *Other Rules.* Under the installment method, you report gain on the sale only as payments are received. It does not matter whether you use the cash or accrual method of accounting.

General Rules

The buyer's ''installment obligation'' to make future payments to you might be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's indebtedness to you. The rules discussed in this publication apply regardless of the form of installment obligation.

Stock or securities. If you use the cash basis method of accounting, you cannot use the installment method to report the sale of stock. You must report the sale of stock or securities traded on an established securities market in the year in which the trade date falls.

Dealer sales. Sales of personal property by anyone who regularly sells or otherwise disposes of property of the same type on the installment plan cannot be reported on the installment method for federal income tax purposes. This also applies to real property held for sale to customers in the ordinary course of the trade or business. However, this does not apply to a sale on the installment plan of any property used or produced in the trade or business of farming.

Special rule. Dealers of timeshares and residential lots can report sales on the installment method if they elect to pay a special interest charge. For more information, see section 453(l) of the Internal Revenue Code.

Sale at a loss. If your sale results in a loss, you may not use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

If your sale calls for payments in a later year, and there is little or no interest provided for in the contract of sale, you may have to figure unstated interest even though you have a loss. See the discussion of unstated interest, later.

Figuring Installment Income

Each payment on an installment sale usually consists of three parts:

1) Return of your investment (basis) in the property sold,

2) Gain on the sale, and

3) Interest.

Each year that you receive payment, you must include in income the interest part of the payment as well as the part of the payment that is your gain. You do not include in income the part of the payment that is the return of your basis in the property sold.

Interest income. You must report interest as ordinary income on your income tax return. Interest is generally not included in a downpayment. However, you may have to treat part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See the discussion of unstated interest, later.

Gain. The rest of each payment is treated as if it were made up of two parts. One part is a return of your investment (basis) in the property you sold. The other part is your gain. The gain is capital gain if the property you sold was a capital asset. However, if you took depreciation deductions on the asset, part of your gain may be treated as ordinary income. See the discussion of depreciation recapture income under *Other Rules,* later.

To determine what part of a payment is gain, multiply the payment by the gross profit percentage. The gross profit percentage is figured by dividing the gross profit (gain) on the sale by the contract price. The following worksheet, gives the basic items you must know to figure the gross profit percentage.

1) Selling price		______
2) Minus the sum of:		
Basis of property sold	______	
Selling expenses	______	______
3) Gross profit (line 1 less line 2)		______
4) Contract price		______
5) Gross profit percentage (line 3 divided by line 4)		______

The following paragraphs discuss in detail each item of the above worksheet.

Selling price. The selling price is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

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 by using the reduced sale price and subtract gain already reported. Then spread the remaining gain evenly over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1992, you sold land with a basis of $40,000 for $100,000 and had a gross profit of $60,000. You received a $20,000 downpayment and the buyer's note for $80,000. The note provides for 4 annual payments of $20,000 each, plus 8% interest, beginning in 1993. Your gross profit percentage is 60%. You reported a gain of $12,000 on each payment received in 1992 and 1993. In 1994, you and the buyer agreed to reduce the purchase price to $85,000 and payments during 1994, 1995, and 1996 are reduced to $15,000 for each year.

Your adjusted gross profit on the sale is $45,000. You subtract the total gain reported in 1992 and 1993, or $24,000, from the adjusted gross profit to determine the remaining gain to be reported. The remaining gain to be reported ($21,000) is divided by the remaining selling price to be received of $45,000 ($85,000 – $40,000) to get the new gross profit percentage of 46.67%. You will report a gain of $7,000 on each of the $15,000 installments due in 1994, 1995, and 1996.

Basis and adjusted basis. Basis is a way of measuring your investment in the property you are selling. The way you figure basis depends on how you first acquired the property. The basis of property you bought is usually its cost to you. The basis of property you inherited, got as a gift, built yourself, or received in a tax-free exchange is figured differently.

While you own personal use property, various events may change your original basis in the property. Some events, such as additions or permanent improvements, increase basis.

Others, such as deductible casualty losses, decrease basis. The result is ***adjusted basis.***

For more information on how to figure basis and adjusted basis, see Publication 551, *Basis of Assets.*

Installment sale basis. The adjusted basis plus selling expenses and depreciation recapture income (see *Other Rules)* is referred to in this publication as the ***installment sale basis.***

Selling expenses. Selling expenses are those that relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Add the selling expenses to the basis of the sold property to determine the gross profit on the sale.

Gross profit. For an installment sale, gross profit is the amount of gain you report on the installment method.

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can postpone or exclude.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments,* later.

If the selling price is partly payable in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. This percentage usually remains the same for each payment you receive. It is called the ''gross profit percentage'' and is figured by dividing your gross profit from the sale by the contract price.

Example. You sell property at a contract price of $2,000 and your gross profit is $500. Your gross profit percentage is 25% ($500 divided by $2,000). After subtracting interest, 25% of each payment, including the downpayment, is reported as your gain from the sale for the tax year the payment is received.

Income from sale. Each year you receive a payment on the installment sale, multiply the payment (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year. In certain circumstances, you may be considered to have received a payment even though you received nothing directly. In addition to the receipt of cash, a receipt of property or the assumption of your mortgage on the property sold may be considered payment. For a detailed discussion, see *Payments* under *Other Rules,* later.

Reporting installment sale income. You must use Form 6252 any time you have a sale of property that you report as an installment sale. Use the form to report the sale in the year it takes place, and to report payments received in later years.

Form 6252 will help you determine the gross profit, contract price, gross profit percentage, and how much of each payment received during the tax year on the sale is included in income.

Form 6252 is divided into three parts:

1) Part I, *Gross Profit and Contract Price,* is completed for the year of sale.
2) Part II, *Installment Sale Income,* is completed for the year of sale and for any year you receive a payment or are considered to have received a payment.
3) Part III, *Related Party Installment Sale Income,* is completed if you sold the property to a related person, as discussed later under *Sales to Related Persons.*

Year of sale. Answer the questions at the beginning of the form and complete Part I and Part II. Question 3 asks whether you sold the property to a related party. If you answer ''Yes'' to question 3, answer question 4 and complete Part III.

Later years. Answer the questions at the beginning of the form and complete Part II for each year in which you receive a payment on the sale. If you sold the property to a related person, you may have to complete Part III also.

Schedule D. The gain figured on Form 6252 for personal use property must be carried over and entered on Schedule D (Form 1040), *Capital Gains and Losses.* Each year, you must include on Schedule D the capital gain part of the payments reported on Form 6252.

If your gain from an installment sale qualifies for long-term capital gain treatment in the year of sale, it will continue to qualify in later tax years. Your gain will be long-term if you owned the property for more than one year when you sold it.

Sale of home. If you sell your home, you may be able to postpone or exclude all or part of the gain on the sale. See *Gain or Loss On the Sale* and *Exclusion of Gain* in Publication 523. If the sale is an installment sale, any gain you can postpone or exclude is not taken into account. Therefore, you figure your gross profit percentage by including in gross profit only the part of the gain that is not postponed or excluded.

Seller-financed mortgages. If you finance the sale of your home to an individual, special reporting procedures apply.

When reporting the interest income, you must report the name, address, and social security number of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A).

When taking the mortgage interest deduction, the buyer must report your name, address, and social security number (or employer identification number) on line 11 of Schedule A (Form 1040).

Both you and the buyer are required to exchange social security numbers (or employer identification number if applicable). If you fail to include the other person's social security number or employer identification number, a penalty of $50 may be asserted against you.

Other Rules

The rules discussed in this part of the publication apply only in certain circumstances or to certain types of property. The rules cover:

Electing out,

Payments,

Escrow accounts,

Depreciation recapture income,

Sales to related persons,

Like-kind exchanges,

Contingent sales,

Single sale of several assets,

Sale of a business,

Unstated interest,

Dispositions of installment obligations, and

Repossessions.

Electing Out

You must report an installment sale using the installment method unless you elect not to use that method. If you make this election, you will generally report the entire gain in the year of sale. Do this even though you will not be paid all of the selling price until later.

To figure the selling price, use the fair market value of the buyer's installment obligation. Notes, mortgages, and land contracts are examples of obligations that are included at fair market value in figuring the selling price.

You must figure the fair market value of the buyer's installment obligation to you, whether or not you would actually be able to sell it. If you use the cash method of accounting, the fair market value of the obligation will never be considered less than the fair market value of the property sold (minus any other consideration received). If you use an accrual method of accounting, you must always use the full face value of the installment obligation as its fair market value.

Example. You sold a parcel of land to another person for $50,000, payable $10,000 down and the balance over a period of 10 years at $4,000 a year, plus 8% interest. The buyer gave you a note for $40,000. The note had a fair market value of $40,000. You paid a commission of 6%, or $3,000, to a broker for negotiating the sale. The land cost you $25,000 and you owned it for more than one year. You decide to elect out of the installment method, and report the buyer's note at its fair market value.

Computation of gain:

Selling price		$50,000
Minus: Adjusted basis of the property	$25,000	
Commission	3,000	28,000
Gain realized		$22,000

Gain recognized in year of sale:

Cash		$10,000
Market value of note		40,000
Total realized in year of sale		$50,000
Minus: Adjusted basis of the property	$25,000	
Commission	3,000	28,000
Gain recognized in year of sale		$22,000

The $22,000 is long-term capital gain. Since you include the full amount of gain in income in the year of sale, you do not include any amount in income when you receive principal payments in later tax years. The interest on the note is ordinary income and is reported as interest income.

How to elect out. To make this election, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever is appropriate.

When to elect out. Make the election not to have the installment method apply by the due date, including extensions, for filing your tax return for the year the sale takes place. Once made, the election generally cannot be changed. However, you can apply to revoke your election not to use the installment method. A revocation of the election will not be permitted when one of its purposes is to avoid federal income tax, or when the tax year in which any payment was received has closed.

You may qualify for an automatic extension of six months from the due date of the return, ***excluding extensions,*** to make this election. See Revenue Procedures 92-85 and 93-28 for more information. You can read the full text of these revenue procedures at most IRS offices and at many public libraries.

Payments

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments include the downpayment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. Its full face value is included when figuring both selling price and contract price. Payments you receive on the note are used to figure your gain in the year you receive them.

Buyer assumes expenses. If the buyer assumes and pays your expenses from selling your property, it is considered a payment to you in the year of sale. Include these expenses in both the selling and contract prices when figuring the gross profit percentage.

Mortgage assumed. If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with an adjusted basis of $19,000. You have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and agrees to pay you a total of $10,000 (a cash downpayment of $2,000 and $2,000 (plus 8% interest) in each of the next 4 years).

The selling price is $25,000 ($15,000 + $10,000). The contract price is $10,000 ($25,000 –$15,000 mortgage). Your gross profit is $5,000 ($25,000 – $20,000 installment sale basis), and your gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, you report half of each $2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage in excess of your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. To this amount, add the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis in the property, the gross profit percentage will always be 100%.

Example. The selling price for your property is $9,000. The buyer will pay you $1,000 annually (plus 8% interest) over the next 3 years, and assume an existing mortgage of $6,000. Your adjusted basis in the property is $4,400. You have selling expenses of $600, for a total installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 – $5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is $4,000:

Selling Price		$ 9,000
Minus Mortgage		(6,000)
Add difference:		
Mortgage	6,000	
Less Installment sale basis	5,000	1,000
Contract Price		**$ 4,000**

Your gross profit on the sale is also $4,000.

Selling Price	$9,000
Minus Installment sale basis	5,000
Gross Profit	**$4,000**

Therefore, your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. You also treat the $1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of sale.

Wraparound mortgages. If your mortgage is not paid off or assumed by the buyer when you sell your property, your installment arrangement with the buyer may be known as a "wraparound mortgage." In a wraparound mortgage, the property's full purchase price is paid in installments directly to you. The installment payments are generally large enough to allow you to continue to make your regular mortgage payments on the property.

To determine the contract price, do not subtract the amount of a wraparound mortgage from the selling price. However, if the mortgage is in fact assumed, or the property taken subject to the mortgage, see *Mortgage assumed,* discussed earlier.

Mortgage canceled. If the buyer of your property is the person who holds the mortgage on it, your debt is not assumed but canceled. You are considered to receive a payment equal to the outstanding amount of the canceled debt.

Example. Mary Jones loaned you $4,500 in 1990 in exchange for a note mortgaging a tract of land you owned. On April 4, 1994, she bought the land for $7,000. At that time, $3,000 remained outstanding on her loan to you. She agreed to forgive this $3,000 debt and to pay you $2,000 (plus interest) on August 1, 1994, and $2,000 (plus interest) on August 1, 1995. She did not assume an existing mortgage. She canceled the $3,000 debt you owed her. The effect is that you received a $3,000 payment at the time of the sale.

Debts. If the buyer pays off any of your debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only a part of it may have to be treated as a payment. Compare the amount of the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. This follows the same rules discussed earlier under *Mortgage assumed.*

However, these rules apply only to two types of debts that the buyer assumes:

1) Those you acquired from your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
2) Those you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, 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 you in the year of sale.

Payments of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Like-Kind Exchanges,* later. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on your sale.

Example. You sold real estate in an installment sale. As part of the downpayment, the buyer assigned you a $5,000, 8% note of a third party. The fair market value of the third-party note at the time of your sale was $3,000. This amount, and not $5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

Bonds. A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's fair market value. Accrual basis taxpayers see section 15A.453–1(e)(2) of the regulations.

Guarantees. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Deposits. Deposits that you receive before the year of sale are treated as payments in the year of sale if, under the contract, they become part of the downpayment.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is known as the pledge rule. The pledge rule applies if the selling price of the property was over $150,000. It does not apply to the sale of:

Property used or produced in the trade or business of farming, or

Personal use property.

The net debt proceeds are the gross amount of the debt minus the direct expenses of getting the debt. The amount treated as a payment is considered received on the later of:

1) The date the debt becomes secured, or
2) The date you receive 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.

Limits. The amount of 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, over
2) Any payments received on the installment obligation before the date the amount of net debt proceeds is treated as a payment.

Installment payments. The pledge rule accelerates the reporting of the installment obligation payments. Do not report payments received on the installment obligation after it has been pledged until the payments received are more than the amount reported under the pledge rule.

Exception. The pledge rule does not apply if the debt is incurred after December 17, 1987, to refinance a debt that was:

1) Outstanding on December 17, 1987, and
2) Secured by that installment sale obligation on that date and at all times thereafter until the refinancing.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt if the refinancing is provided by a person other than the creditor or a person related to the creditor.

This exception applies only to the amount of the refinancing that does not exceed the principal amount of the original debt immediately before the refinancing. Any excess amount is treated as a payment on the installment obligation.

Escrow Accounts

In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account out of which the remaining installment payments (including interest) are to be made. Generally, these sales may not 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, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

Example. You sell property for $10,000. The sales agreement calls for a downpayment of $1,000 and payment of $1,500 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. You may not report the sale on the installment method because the full purchase price is considered received in the year of sale. You must report all your gain in the year of sale.

Escrow established in a later year. If you make an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation. Therefore, you cannot use the installment method to report any payments you receive from the escrow account. This is because a disposition has occurred. See *Dispositions of Installment Obligations,* later.

Substantial restriction. If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer.

Example. You sell your business including all its assets for $50,000. The sales agreement provides for a downpayment of $8,000 and payments of $7,000 in each of the next 6 years to be made from an irrevocable escrow account. The sales agreement also provides that you, the seller, will not enter a competing business for a period of 6 years. If at any time during this period you enter a competing business, you will forfeit all rights to the amounts then held in escrow. In this situation, the escrow arrangement imposes a substantial restriction and you can use the installment method.

Depreciation Recapture Income

If you sell property for which you claimed depreciation deductions, report any depreciation recapture income in the year of sale. Figure your depreciation recapture income (including the ***section 179 deduction and the section 179A deduction*** recapture) in Part III of Form 4797. Report the recapture income in Part II of

Form 4797 as ordinary income in the year of sale. You cannot use the installment method to report your gain that is equal to the recapture income. Any gain that is more than the recapture income can be reported on the installment method. For more information on the section 179 deduction, see Publication 534. For more information on the section 179A deduction, see Chapter 15 in Publication 535. For more information on depreciation recapture, see Chapter 4 in Publication 544.

To figure your gross profit on the installment sale, subtract the installment sale basis from the selling price. Installment sale basis is defined earlier under *General Rules.*

Sales to Related Persons

Two special rules apply to installment sales between related persons. Test your sale against rule 1 first. If rule 1 does not apply, test your sale against rule 2.

For more information on these kinds of sales, see section 453 of the Internal Revenue Code.

Rule 1: Sale of Depreciable Property

If you sell depreciable property to certain related persons, you may not report the sale using the installment method. Instead, all payments to be received are considered received in the year of sale. Depreciable property for this rule is any property that can be depreciated by the person or entity to whom you transfer it.

Payments to be received include the total of all payments which are not contingent and the fair market value of any payment that is contingent as to amount.

For any payments which are contingent as to amount but for which the fair market value is not reasonably ascertainable, the basis is recovered ratably. The purchaser may not increase the basis of any property acquired in the sale by any amount before the time the seller includes the amount in income.

Exceptions to rule 1. Rule 1 will not apply to your sale if no significant tax deferral benefits will be derived from the sale. It does not apply if you can show to the satisfaction of IRS that avoidance of federal income taxes was not one of the principal purposes of your sale.

Rule 2: Sale and Resale

There is, generally, a special rule if you make a first disposition (sale or exchange) that you report under the installment method to a related person who then makes a second disposition (sale, exchange, gift, or cancellation of installment note):

Before making all payments on the first disposition, and

Within 2 years of the first disposition.

Under this rule, you treat part or all of the amount the related person realizes (or the fair market value if disposed property is not sold or exchanged) from the second disposition as if you received it from the first disposition at the time of the second disposition.

Example 1. In 1993, Harvey Green sold farmland to his son Bob for $500,000, which was to be paid in five equal payments over 5 years, plus adequate stated interest on the balance due. Harvey's installment sale basis for the farmland was $250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (his gross profit of $250,000 divided by the contract price of $500,000). Harvey received $100,000 in 1993 and included in his income for that year $50,000 ($100,000 ×0.50). Bob made no improvements to the property and in 1994 sold it to Alfalfa Inc. for $600,000. This is the amount realized from the second disposition. Harvey figures his installment sale income for 1994 as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less	$500,000
Minus: Sum of payments from Bob in 1993 and 1994	200,000
Amount treated as payment because of second disposition	$300,000
Add: Payment from Bob in 1994	100,000
Total payments received and treated as received for 1994	$400,000
Multiply by gross profit percentage	.50
Installment sale income for 1994	$200,000

Harvey will not include in his income from installment sales any principal payments he receives on the installment obligation for 1995, 1996, and 1997 because he has already reported the entire amount of the payments from the first disposition of $500,000 ($100,000 in 1993 and $400,000 in 1994).

Example 2. The facts are the same as in the previous example except that Bob sells the property for only $400,000. The gain for 1994 is figured as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less	$400,000
Minus: Sum of payments from Bob in 1993 and 1994	200,000
Amount treated as payment because of second disposition	$200,000
Add: Payment from Bob in 1994	100,000
Total payments received and treated as received for 1994	$300,000
Multiply by gross profit percentage	.50
Installment sale income for 1994	$150,000

In 1995 Harvey receives a payment of $100,000 from Bob which is not taxed. It is considered to be recovered tax free because Harvey already reported the payment and gain in 1994 as the result of the $200,000 which he treated as a payment even though he did not actually receive it. He applies the $100,000 payment in 1995 against this amount. He is also not taxed on the payment he receives in 1996 and he applies the payment against the $200,000 he treated as payment in 1994. In 1997, he receives the final $100,000 payment. He figures the amount of gain he must recognize in 1997 from the installment sale as follows:

Sum of payments actually received as of the end of 1997 from the first disposition		$500,000
Minus the sum of:		
Payment from 1993	$100,000	
Payment from 1994	100,000	
Amount treated as payment in 1994	200,000	
Total of amounts on which gain was previously recognized		400,000
Amount of payment on which gain is to be recognized for 1997		$100,000
Multiply by gross profit percentage		.50
Installment sale income for 1997		$ 50,000

Exceptions to rule 2. These rules do not apply to a second disposition, and any later transfer, if you can show, to the satisfaction of the IRS, that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, the second disposition will qualify under the nontax avoidance exception in situations when it is involuntary, such as a creditor of the related person foreclosing on the property or the related person declaring bankruptcy.

The nontax avoidance exception will also apply to a second disposition that is also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception does not apply if the resale terms permit significant deferral of recognition of gain from the first sale as, for example, if amounts from the resale are collected sooner.

In addition, the sale or exchange of stock to the issuing corporation is not treated as a first disposition. An involuntary conversion is not treated as a second disposition if the first disposition occurred before threat of conversion. A transfer after the death of the person making the first disposition or the related person's death, whichever is earlier, is not treated as a second disposition.

Like-Kind Exchanges

If you trade your business or investment property for other property of the same kind, you can postpone reporting part of your gain. These trades are known as "like-kind exchanges." The property you receive in a like-kind exchange is treated as if it were a continuation of the property you give up.

In a like-kind exchange, you do not have to report any part of your gain if you receive only like-kind property. But if you also receive money or other property, you must report your gain to the extent of the money and the fair market value of the other property received.

Installment payments. If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply:

1) The contract price must not include the fair market value of the like-kind property received in the trade.
2) The gross profit is reduced by any gain on the trade that can be postponed.
3) Like-kind property received in the trade is not considered payment on the installment obligation.

Example. In 1994, George Brown trades personal property with an installment sale basis of $400,000 for like-kind property having a fair market value of $200,000. He also receives an installment note for $800,000 in the trade. Under the terms of the note, he is to receive $100,000 (plus interest) in 1995 and the balance of $700,000 (plus interest) in 1996.

George's gross profit is $600,000 (selling price of $1,000,000 minus $400,000 installment sale basis). The contract price is $800,000 ($1,000,000 minus the fair market value of the like-kind property received, $200,000). The gross profit percentage is 75% ($600,000 divided by $800,000). He reports no gain in 1994 because the like-kind property he receives is not treated as payment for figuring gain. He reports $75,000 gain for 1995 (75% of $100,000) and $525,000 gain for 1996 (75% of $700,000).

For more information on like-kind exchanges, see *Like-Kind Exchanges* in Publication 544.

Deferred exchanges. A deferred exchange is one in which you have transferred the property and are to receive like-kind property at a later date. Under this type of exchange, the person receiving your property may be required to place funds in an escrow account or trust. If certain rules are met, these funds will not be considered a payment until you have the right to receive the funds or, if earlier, the end of the exchange period. See section 1.1031(k)-1(j)(2) of the regulations for these rules.

Contingent Sales

For installment sales, a contingent sale is one whose total selling price cannot be determined by the end of the tax year in which the sale takes place.

If the selling price cannot be determined by the end of the tax year, neither can the contract price and the gross profit percentage be determined (using the same rules that apply to an installment sale with a fixed selling price). This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years.

For rules permitting use of the installment method to report a contingent sale and for contingent sales with unstated interest, see section 15A.453–1(c) of the regulations.

Single Sale of Several Assets

If you sell two or more assets in a single sale to one buyer and there is more than one class of asset, you must allocate all payments among the different classes of assets. Do this in proportion to their respective selling prices.

The arm's-length allocation of the selling price and of payments received in the year of sale will be acceptable if substantiated by all the facts and circumstances. However, an allocation that is not based on the respective selling prices of the assets sold is not acceptable.

You must allocate the downpayment and payments received from installment obligations on the basis of the proportionate net fair market value of the assets if:

The asset is encumbered by debts assumed by the buyer, or

The asset is taken subject to a debt, and an arm's length allocation of the downpayment or other payments to be received was not made.

The ***net fair market value*** of any asset is its fair market value (FMV) reduced by any debt the buyer assumes or any debt to which the asset is subject.

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

Example. You sold three separate and unrelated parcels of real property, A, B, and C, under a single contract calling for a total selling price of $130,000. The total selling price of $130,000 consisted of a cash payment of $20,000, the buyer's assumption of a $30,000 mortgage on parcel B, and an installment obligation of $80,000 payable in eight annual installments, plus interest at 8% a year.

Your installment sale basis for each parcel was $15,000. Thus, your net gain was $85,000 ($130,000 minus $45,000). You report the gain on the installment method.

The sales contract did not allocate the selling price or the cash payment received in the year of sale among the individual parcels. The FMV of parcel A, B, and C were $60,000, $60,000, and $10,000, respectively. Since the installment sale basis for parcel C was more than its FMV, it was sold at a loss and it must be treated separately.

You must allocate the total selling price and the amounts received in the year of sale between parcel C sold at a loss and the remaining parcels.

The total selling price of $130,000 is allocated $120,000 for parcels A and B together and $10,000 for parcel C. The cash payment of $20,000 received in the year of sale and the note receivable should be allocated on the basis of the proportionate net FMV. The allocation is as follows:

Net FMV	Parcels A and B	Parcel C
FMV	$120,000	$10,000
Minus: Mortgage assumed	30,000	–0–
Net FMV	$ 90,000	$10,000
Proportionate net FMV		
Percentage of total	90%	10%
Payments in year of sale		
$20,000 × 90%	$ 18,000	
$20,000 × 10%		$ 2,000
Excess of mortgage on parcel B over its installment sale basis	15,000	
Allocation of payments received in year of sale	$ 33,000	$ 2,000

The sale of parcel C may not be reported on the installment method because the sale results in a loss. This loss of $5,000 ($10,000 selling price minus $15,000 installment sale basis) is reported in the year of sale. However, if parcel C was held for personal use, the loss is not deductible.

The installment obligation of $80,000 is allocated to the property sold based on the proportionate net FMV. Ninety percent of each payment received is allocated to parcels A and B, and 10% is allocated to parcel C.

Sale of a Business

The installment sale of an entire business, operated as a sole proprietorship, for one overall price under a single contract is not the sale of a single asset. The sale generally includes the sale of real and personal property that can be reported on the installment method, and inventory items that cannot be reported on the installment method. The sale of depreciable property cannot be reported on the installment method to the extent the gain is reported in the year of sale because it is depreciation recapture income. Assets sold at a loss cannot be reported on the installment method. The selling price must be allocated for each asset class.

For more information, see *Sale of a Business,* in Publication 544.

Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the residual method to allocate the sales price to the various business assets transferred. This method determines the gain or loss from the transfer of each asset.

The residual method must be used for any transfer of a group of assets that continues 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. A group of assets constitutes a trade or business if goodwill could, under any circumstances, attach to the assets.

The residual method provides for the sales price to be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. The amount of sales price remaining after this reduction must be allocated among the various business assets in a specified order.

The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value on the purchase date in the following order:

1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency,
2) All other assets except section 197 intangibles, and
3) Section 197 intangibles.

For more information on section 197 intangibles, see Chapter 12 in Publication 535.

How to report. To report information on the allocation, you must use Form 8594, *Asset Acquisition Statement Under Section 1060,* or a statement that includes:

1) Amount of sale (purchase),
2) Allocation of the sales (purchase) price to goodwill or going concern value, and
3) Any information concerning subsequent increases or decreases to the sales (purchase) price.

For more information on goodwill, see *Sale of a Business* in Publication 544.

Inventory. If inventory items are included in an installment sale, you may have an agreement with the buyer concerning which payments are for inventory and which are for the other assets being sold. If you do not have an agreement, each payment must be allocated between the inventory and the other assets sold.

However, the sale of inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if you are paid in later years.

The amount you receive (or will receive) on the sale of inventory items is reported as ordinary business income. Your basis in the items is used to figure the cost of goods sold, and the part of the selling expenses allocated to inventory is deducted as an ordinary business expense.

Notes received. If inventory items are included in an installment sale, and the fair market value of the buyer's notes is less than their face value at the time you receive them, figure gain on the inventory items on the fair market value of the notes rather than on their face value. This is true even though you report gains on other items in the sale on the installment method and figure those gains on the basis of the face value of the notes.

Installment reporting for sale of partnership interest. 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, you must make an allocation if the partnership's assets included unrealized receivables and substantially appreciated inventory items. (The term ''unrealized receivables'' includes depreciation recapture income, discussed earlier.)

The gain allocated to the recapture income and the substantially appreciated inventory cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method.

For more information on unrealized receivables and substantially appreciated inventory, see Publication 541, *Tax Information on Partnerships.*

Example

On January 4, 1994, you sold the machine shop you operated since 1984. You received a $100,000 downpayment and the buyer's note for $120,000. The note payments are $15,000 each, plus 10% interest, due every July 1 and January 1, beginning in 1995. The total selling price is $220,000. Your selling expenses are $11,000. The selling expenses are divided among all the assets sold, including inventory.

Your selling expense for each asset is 5% of the asset's selling price ($11,000 selling expense divided by $220,000 total selling price).

The fair market value (FMV), adjusted basis, and depreciation claimed on each asset sold are as follows:

Asset	FMV	Depreciation Claimed	Adjusted Basis
Inventory	$10,000	—	$ 8,000
Land	42,000	—	15,000
Building	48,000	$ 9,000	36,000
Machine A	71,000	27,200	63,800
Truck	6,500	18,624	5,376
Machine B	24,000	12,960	22,040

Under the residual method, you allocate the selling price to each of the assets based on their FMV ($201,500). The remaining amount is allocated among your section 197 intangibles, which includes goodwill ($18,500). For more information on section 197 intangibles, see Chapter 12 in Publication 535.

The assets included in the sale, their selling prices based on their fair market values, the selling expense allocated to each asset, the adjusted basis and the gain for each asset are shown in the following chart.

	Selling price	Selling expense	Adjusted basis	Gain
Inventory	$ 10,000	$ 500	$ 8,000	$ 1,500
Land	42,000	2,100	15,000	24,900
Building	48,000	2,400	36,000	9,600
Machine A	71,000	3,550	63,800	3,650
Truck	6,500	325	5,376	799
Machine B	24,000	1,200	22,040	760
Goodwill	18,500	925	0	17,575
	$220,000	$11,000	$150,216	$58,784

The building which was acquired in 1984, the year the business began, is section 1250 property. There is no depreciation recapture income because the building was depreciated using the straight line method.

All gain on the truck, machine A, and machine B is depreciation recapture income. Depreciation recapture income is the lesser of the depreciation claimed or the gain. Figure depreciation recapture in Part III of Form 4797.

The total depreciation recapture income reported in Part II of Form 4797 is $5,209. This is made up of $3,650 on machine A, $799 on the truck, and $760 on machine B. Gain on these items is reported in full. Therefore, they are not included in the installment sale computation.

Of the $220,000 total selling price, $10,000 is for inventory assets that cannot be reported on the installment method. The selling prices of the truck and machines are also removed from the total selling price because gain on these items is reported in the year of sale.

The selling price and contract price for the installment sale are $108,500. The assets included in the installment sale, their selling price, and their installment sale basis are shown in the following chart.

	Selling price	Installment sale basis	Gross profit
Land	$ 42,000	$ 17,100	$24,900
Building	48,000	38,400	9,600
Goodwill	18,500	925	17,575
Total	$108,500	$ 56,425	$52,075

The ***gross profit percentage*** (gross profit divided by the contract price) for the installment sale is 48% ($52,075 ÷ $108,500). The gross profit percentage for each asset is figured as follows:

	Percentage
Land—$24,900 divided by $108,500	22.95
Building—$9,600 divided by $108,500	8.85
Goodwill—$17,575 divided by $108,500	16.20
Total	48.00

The sale includes assets sold on the installment method and assets for which the gain is reported in the year of sale. The payments must be allocated to the installment sale and the sale of assets that is reported in the year of sale. The selling price for the installment sale is $108,500. This is 49.3% of the total selling price of $220,000. You get this percent by dividing $108,500 by $220,000. The selling price of the assets that cannot be reported on the installment method is $111,500. This is 50.7% ($111,500 ÷ $220,000) of the total selling price.

Determine the part of any payment that is for the installment sale by multiplying the payment by 49.3%. The balance of the payment, 50.7%, is for the part of the sale not on the installment method.

The gain on the sale of the inventory, machines, and truck is reported in the year of sale. When you receive principal payments in later years, no part of the payment that is for the sale of these assets is included in gross income. Only the part of the principal payment (49.3%) that is for the installment sale is used in the installment sale computation.

The only payment received in 1994 is the downpayment of $100,000. The part of the payment that is for the installment sale is $49,300 ($100,000 × 49.3%). This amount is used in the installment sale computation.

Installment income for 1994. Your installment income for each asset is the gross profit percentage for that asset times the total amount received in 1994 on the installment sale.

The total amount received in 1994 on the installment sale is $49,300.

	Income
Land—22.95% of $49,300	$11,314
Building—8.85% of $49,300	4,363
Goodwill—16.2% of $49,300	7,987
Total installment income for 1994	$23,664

Installment income after 1994. You figure installment income for years after 1994 by applying the same gross profit percentages to 49.3% of the total payments you receive on the buyer's note during the year.

Unstated Interest

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

If an installment sale with some or all payments due more than one year after the date of sale does not provide for interest, part of each payment due more than 6 months after the date of sale will be treated as interest. The amount treated as interest is referred to as ***unstated interest*** or ***imputed interest.***

When the stated interest in the contract is under the applicable federal rate (AFR), the unstated interest is the difference between the federal rate of interest and any interest specified in the sales contract.

Generally, the unstated interest rules do not apply to a debt given in consideration for a sale or exchange of personal-use property. Personal-use property is any property substantially all of the use of which by the buyer is not in a trade or business or an investment activity.

Applicable federal rate (AFR). The AFR depends on the month the binding contract for the sale or exchange of property is made and the term of the instrument. For an installment obligation, the term of the instrument is its weighted average maturity, as defined in section 1.1273–1(e)(3) of the regulations.

- If the term is three years or less, the AFR is the federal short-term rate.
- If the term is over three years, but not over nine years, the AFR is the federal mid-term rate.
- If the term is over nine years, the AFR is the federal long-term rate.

The applicable federal rates are published monthly by IRS in the Internal Revenue Bulletin.

Effects of unstated interest. Imputed interest affects the selling price and the contract price. It also affects the amount of gain on the sale, whether you use the installment method or elect out.

If the unstated interest rules apply, both the buyer and the seller must treat part of the installment sale price as interest. The unstated interest rules require you to treat part of each payment as interest, even though it is not called interest in your agreement with the buyer. The amount of unstated interest reduces the stated selling price of the property and increases the seller's interest income. The unstated interest reduces the buyer's basis in the property and increases the buyer's interest expense.

Selling price and contract price. If you use the installment method to report gain on the sale, both the selling price and the contract price must be reduced by any imputed interest. All other rules relating to installment sales apply as if there were no imputed interest.

If you elect out of the installment method. If you do not report your sale using the installment method, report your entire gain in the year of sale. However, if you find that payments you receive include imputed interest, you must reduce the selling price by the total amount of imputed interest before you can determine the gain or loss.

The amount of interest you must report is the sum of the imputed interest plus any interest specified under the contract.

Rules for Imputing Interest

A debt instrument must provide for adequate stated interest. If a debt instrument does not provide for adequate stated interest, interest is imputed on the debt. Generally, a debt instrument provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest applicable to the debt instrument.

Test rate of interest. The test rate of interest for a debt instrument is the 3-month rate. The 3-month rate is the lower of

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 sets forth the terms under which the sale or exchange is ultimately consummated, or
2) The lowest AFR in effect during the 3-month period ending with the month in which the sale or exchange occurs.

If there is no binding written contract that sets forth the terms under which the sale or exchange is to be consummated, use the lowest AFR that is in effect during the 3-month period ending with the month in which the sale or exchange occurs.

For sales or exchanges of property (other than new section 38 property, which includes most tangible personal property) involving seller financing of $3,433,500 or less, the test rate of interest cannot be more than 9%, compounded semiannually. For seller financing over $3,433,500, and for all sales or exchanges of new section 38 property, the test rate of interest is 100% of the AFR.

For information on new section 38 property see section 48(b) of the Internal Revenue Code, as in effect before the enactment of Public Law 101–508.

Relationship of Code sections 1274 and 483. The imputed interest rule is imposed under section 1274 or 483 of the Code, depending on the characteristics (amount, kind of property, etc.) of the debt instrument and the sale or exchange it comes from.

Section 1274 applies to any debt instrument issued for the sale or exchange of property if some or all payments due under the debt instrument are due more than 6 months after the date of sale or exchange. Section 483 applies to sales or exchanges of property not covered by the provisions of section 1274.

Section 483 rules. For a sale or exchange of property, the section 483 rules apply to any payment that constitutes all or part of the selling price and that is due more than 6 months after the date of sale or exchange under a contract by which:

1) Some or all payments are due more than 1 year after the date of sale or exchange, and
2) There is total unstated interest (or inadequate stated interest).

Total unstated interest. Total unstated interest is an amount equal to the excess of:

1) The sum of payments due under the contract, over
2) The sum of the present values of payments and the present values of any interest payments due under the contract.

Transactions to which section 483 rules apply. The section 483 rules apply to debt instruments from sales or exchanges of:

1) A farm for $1,000,000 or less by an individual, estate, testamentary trust, small business corporation (defined in section

1244(c)(3) of the Code), or a domestic partnership that meets requirements similar to those of section 1244(c)(3),

2) A principal residence by the owner,

3) Property with total payments (principal and interest) of $250,000 or less, or

4) Qualified sale of land between related parties.

In addition, the section 483 rules apply to a ***cash method debt instrument.*** A cash method debt instrument is any debt instrument given as consideration for the sale or exchange of property (other than new section 38 property) with a stated principal amount of $2,452,500 or less and:

1) The lender (holder) 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 (issuer) and the lender jointly elect to account for interest under the debt instrument on the cash method of accounting, and

3) Section 1274 of the Code would apply except for the election in (2) above.

Sale of a farm. The section 483 rules apply to the sale of a farm if the selling price cannot exceed $1,000,000. If the selling price can exceed $1,000,000, the section 1274 rules (discussed later) apply. For determining the selling price, all sales and exchanges that are part of the same transaction (or a series of transactions) are treated as one sale or exchange.

Sales with total payments of $250,000 or less. The section 483 rules apply if the following cannot exceed $250,000:

1) The total payments (interest and principal) due under the debt instrument and under all other debt instruments received as consideration for the sale or exchange, and

2) The total other consideration to be received for the sale or exchange.

The section 1274 rules apply if the amount can exceed $250,000.

Any consideration (other than a debt instrument) is taken into account at its fair market value. All sales and exchanges that are part of the same transaction (or series of related transactions) are treated as one sale or exchange.

Land sales between related parties. The section 483 rules apply to debt instruments issued in land sales between related parties to the extent that the stated principal amount of the debt instrument issued in the sale or exchange does not exceed $500,000 when added to the total stated principal amount of any other debt instruments for prior land sales between these individuals during the calendar year. The section 1274 rules, if otherwise applicable, apply to debt instruments issued in a sale of land to the extent the stated principal amount is in excess of $500,000, or if any party to the sale is a nonresident alien individual.

Related parties 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, brother and sister (whether by whole or half blood), ancestors, and lineal descendants.

Exceptions to section 483 rules. The unstated interest rules do not apply to the following types of transactions.

Sales price of $3,000 or less. If it can be determined at the time of sale or exchange of the property that the selling price will not exceed $3,000, the unstated interest rules do not apply to the sale or exchange.

Carrying charges. The buyer of personal property need not figure unstated interest if any part of the payments includes separately stated carrying charges.

Additional exceptions. See the discussion of the exceptions that apply to both sections 483 and 1274, later.

Section 1274 rules. The section 1274 rules apply to any debt instrument given in consideration for the sale or exchange of property if:

1) The stated redemption price at maturity for the debt instrument exceeds:

   a) The stated principal amount when there is adequate stated interest, or

   b) The imputed principal amount in all other cases, and

2) Some or all payments under the debt instrument are due more than 6 months after the date of the sale or exchange.

There is adequate stated interest under section 1274 if the stated principal amount for a debt instrument is less than or equal to the imputed principal amount. The imputed principal amount of any debt instrument is equal to the sum of the present values of all payments under the debt instrument. If a debt instrument has a single fixed interest rate that is paid or compounded at least annually, and the rate is equal to or greater than the test rate, there is adequate stated interest.

In transactions to which these rules apply, the issue price of the debt instrument has to be determined. Where there is adequate stated interest, the issue price is the stated principal amount. If the debt instrument does not provide for adequate stated interest, the issue price of the instrument is the imputed principal amount of the debt instrument. The issue price of a debt instrument is generally used to determine the sale price (in whole or in part) of any property acquired for the debt instrument.

Exceptions to the imputed principal rules. The imputed principal rules do not apply to any of the debt instruments involved in transactions listed earlier under *Transactions to which section 483 rules apply.* (Also see *Exceptions to sections 483 and 1274,* later.)

Assumptions. Do not apply the imputed interest rules to a debt instrument if it is assumed or the property is taken subject to the debt instrument. However, you would apply these rules if the terms or conditions of the debt instrument are modified or the nature of the transaction is changed.

Exceptions to sections 483 and 1274. The imputed interest rules do not apply in the following circumstances.

Publicly traded debt instruments or property. Transactions involving publicly traded debt instruments or any debt instrument issued in consideration for the sale or exchange of publicly traded property are not subject to the imputed interest rules. A publicly traded instrument is one that is traded on an established securities market.

Patents. When all substantial rights to a patent, or an undivided interest in property that includes part of all substantial rights to a patent, is sold or exchanged, do not figure unstated interest or imputed principal on any amount contingent on the productivity, use, or disposition of the property transferred. This rule will apply only if long-term capital gain or loss treatment applies to the sale (see Publication 544).

Annuities. Payments that depend in whole or in part on the life expectancy of any individual do not require the computation of unstated interest or imputed principal.

Additional information. For information on the computation of imputed interest and other special rules, see sections 483 and 1274 of the Code and the regulations thereunder.

Dispositions of Installment Obligations

A disposition generally includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation. An ***installment obligation*** is the buyer's note, deed of trust, or other evidence that the buyer will make future payments to you.

If you are using the installment method and you dispose of the installment obligation, you will usually have a gain or loss to report. The gain or loss is considered to be gain or loss on the sale of the property for which you received the installment obligation. If the original installment sale of the property produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss.

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

If you ***sell or exchange the obligation,*** or if you accept less than face value in satisfaction of the obligation, the gain or loss is the difference between your basis in the obligation and the amount you realize.

If you ***dispose of the obligation in any other way,*** the gain or loss is the difference between your basis in the obligation and its fair market value at the time of the disposition. This rule applies, for example, when you give the installment obligation to someone else or cancel the buyer's debt to you.

Basis. Your basis in an installment obligation depends on the unpaid balance on the obligation and your gross profit percentage.

Multiply the unpaid balance by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

Example. Several years ago, you sold some property on the installment method. The buyer still owes you $10,000 of the sales price. This is the unpaid balance on the buyer's installment obligation to you. Because your gross profit percentage is 60%, $6,000 (60% of $10,000) is the profit owed you on the obligation. The rest of the unpaid balance, $4,000, is your basis in the obligation.

Transfers between spouses or former spouses. No gain or loss is recognized on the transfer of an installment obligation between a husband and wife or a former husband and wife if 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 for the transferred obligation applies to the spouse or former spouse receiving it as applied to the transferor spouse or former spouse. The basis of the obligation to the transferee spouse (or former spouse) is the adjusted basis of the transferor spouse.

The nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

Gifts. A gift of an installment obligation is a disposition. The gain or loss is the difference between your basis in the obligation and its fair market value at the time you make the gift.

For gifts between spouses or former spouses, see *Transfers between spouses or former spouses,* earlier.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value at the time you cancel it. If the parties are related, the fair market value of the obligation is considered to be no less than its full face value.

Forgiving part of the buyer's debt. If you accept part payment on the balance of the buyer's installment debt to you and forgive the rest of the debt, you treat the settlement as a disposition of the installment obligation. The gain or loss is the difference between your basis in the obligation and the amount you realize on the settlement.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to payments you receive after the reduction.

Assumptions. If the buyer of your property sells it to someone else and you agree to let the new buyer assume the original buyer's installment obligation, you have not disposed of the installment obligation. It is not a disposition even if the new buyer pays you a higher rate of interest than the original buyer.

Installment obligations transferred because of death. The transfer of an installment obligation as a result of the death of the seller or other holder of the obligation is not a disposition. Any unreported gains from the installment obligations are not treated as items of gross income to the decedent. No income is required to be reported on the decedent's return due to this transfer. This means that whoever receives the installment obligation as a result of the holder's death is taxed on the installment payments as the seller or other holder would have been if the holder lived to receive payments.

However, if an installment obligation is canceled, becomes unenforceable, or transferred to the buyer, because of the death of the holder of the obligation, it is a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related, the fair market value of the installment obligation is considered to be no less than its full face value.

Repossessions

If, after making an installment sale, you repossess your property from the buyer, you must figure:

1) Your gain (or loss) on the repossession, and
2) Your basis in the repossessed property.

The rules for doing this depend on the kind of property you repossess. The rules for repossessions of personal property differ from those for real property. Special rules may also apply if you repossess property that was your principal residence before the sale.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. Nor does it matter how you repossess the property, whether you foreclose or the buyer voluntarily surrenders the property to you. However, it is not a repossession if the buyer puts the property up for sale and you repurchase it.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to you. The discharged obligation must be secured by the property you repossess. This requirement is met if the property is auctioned off after you foreclose and you apply the installment obligation to your bid price at the auction.

Reporting the repossession. You report gain or loss from a repossession on the same form you used to report the original sale. If you reported the sale on Form 4797, use Form 4797 to report the gain or loss on the repossession.

Personal Property

If you repossess personal property, you may have a gain or a loss on the repossession. In some cases, you may also end up with a bad debt.

To figure your gain or loss, subtract your basis in the installment obligation and any expenses you have for the repossession from the fair market value of the property. If you receive anything from the buyer in addition to the repossessed property, it is added to the property's fair market value before making this subtraction.

The way you figure your basis in the installment obligation depends on whether or not you reported the original sale using the installment method. The method you used to report the original sale also affects the character of your gain or loss on the repossession.

For sales not reported on the installment method:

Basis. Your basis in the installment obligation is figured on its full face value or its fair market value at the time of the original sale, whichever you used to figure your gain or loss in the year of sale. From this amount, subtract all the payments of principal you have received on the obligation. The result is your basis in the installment obligation. If only a part of the obligation is discharged by the repossession, figure your basis only in that part.

Gain or loss. To your basis in the obligation, add any repossession expenses. If the fair market value of the property you repossess is more than this total, you have a gain. Because the gain is gain on the installment obligation, it is all ordinary income. If the fair market value of the repossessed property is less than the total of basis plus repossession expenses, you have a loss. Because the loss is a loss on the installment obligation, it is a bad debt loss. How you deduct the loss depends on whether you sold business or nonbusiness property in the original sale. See Publication 550, *Investment Income and Expenses,* for more information on nonbusiness bad debts and Chapter 14 of Publication 535, *Business Expenses,* for information on business bad debts.

For sales reported on the installment method:

Basis. Multiply the unpaid balance of your installment obligation by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

Gain or loss. Your gain or loss on the repossession is the same character as your gain on the original sale. If you had a long-term capital gain on the original sale, you have a long-term capital gain or loss on the repossession. If your original gain was ordinary, your gain or loss on the repossession is also ordinary.

The following worksheet can be used to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

1) FMV of property repossessed		______
2) Unpaid balance of installment obligation	______	
3) Unrealized profit (amount on line 2 times gross profit percentage)	______	
4) Basis of obligation (amount on line 2 minus amount on line 3)	______	
5) Plus: Repossession costs	______	______
6) Gain or loss on repossession (amount on line 1 minus amount on line 5)		______

Example. You sold your piano for $1,500 in December 1993 for $300 down and $100 a month (plus interest). The payments began in January 1994. Your gross profit percentage is 40%. You reported the sale on the installment method on your 1993 income tax return. After the fourth monthly payment, the buyer defaults on the contract (which has an unpaid balance of $800) and you are forced to foreclose on the piano. The FMV of the piano on the date of repossession is $1,400. The legal costs of foreclosure and the expense of moving the piano back to your home total $75. You figure your gain on the repossession as follows:

1) FMV of property repossessed		$1,400
2) Unpaid balance of installment obligation	$800	
3) Unrealized profit (amount on line 2 times gross profit percentage)	320	
4) Basis of obligation (amount on line 2 minus amount on line 3)	480	
5) Plus: Repossession costs	75	555
6) Gain or loss on repossession (amount on line 1 minus amount on line 5)		$845

Basis in repossessed property. Your basis in repossessed personal property is its fair market value at the time of the repossession.

Fair market value. The fair market value of repossessed property is a question of fact to be established in each case. If you bid for the property at a lawful public auction or judicial sale, its fair market value is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

Bad debt. If the installment obligation is not fully satisfied by the repossession, the same circumstances that led you to repossess your property may mean that you cannot collect on the rest of the buyer's debt to you. If you cannot, you may be able to take a bad debt deduction for that part of the installment obligation. See Publication 550 for more information on nonbusiness bad debts and Chapter 14 of Publication 535 for information on business bad debts.

Real Property

The rules for repossessions of real property allow you to keep essentially the same adjusted basis in the repossessed property as you had before the original sale. You can recover this entire adjusted basis when you resell the property. This, in effect, cancels out the tax treatment you had on the original sale, and puts you in the same tax position you were in before that sale.

Therefore, the full amount of any payments you already received from the buyer on the original sale must be regarded as income to you. You report, as gain on the repossession, any part of those payments that you did not yet include in your income. This would be the part that was regarded as a return of your adjusted basis rather than as gross profit. However, the total gain you report is limited, as discussed later.

Conditions. The rules given below are ***mandatory.*** You must use them to figure your basis in the repossessed real property and your gain on the repossession. They apply whether or not you reported the sale on the installment method. However, they apply only if all the following conditions are met:

First, the repossession must be to protect your security rights in the property.

Second, the installment obligation satisfied by the repossession must have been received in the original sale.

Third, you cannot pay any additional consideration to the buyer to get your property back, unless either:

a) The reacquisition and payment of the additional consideration were provided for in the original contract of sale, or

b) The buyer has defaulted, or default is imminent.

''Additional consideration'' includes money and other property you pay or transfer to the buyer. For example, additional consideration is present if you reacquire the property subject to an indebtedness that arose after the original sale.

Conditions not met. If any of these three conditions is not met, use the rules discussed under *Personal Property,* earlier, as if the property you repossess is personal rather than real property. Do not use the rules for real property.

Figuring gain on repossession. Your gain on repossession is the difference between:

The total payments received, or considered received, on the sale, and

The total gain already reported as income.

See the earlier discussion under *Payments* for the definition of what is considered a payment on the sale.

Limit on taxable gain. There is a limit on the amount of gain that is taxable. Taxable gain is limited to your gross profit on the original sale, minus the sum of:

1) The gain on the sale you reported as income before the repossession, and

2) Your repossession costs.

This method of figuring taxable gain, in essence, treats all payments you received on the sale as income, but limits your total taxable gain to the gross profit you originally expected on the sale.

Repossession costs. Your repossession costs include money or property you pay for the reacquisition of the real property. This includes amounts paid to the buyer of the property as well as amounts paid to others for such items as:

- court costs
- legal fees
- publication, acquiring, filing or recording title
- clearing liens

Repossession costs do not include the fair market value of the buyer's obligations to you that are secured by the real property.

Worksheet. The following worksheet can be used to determine the taxable gain on a repossession of real property reported on the installment method.

1) Payments received before repossession	_____	
2) Minus: Gain reported	_____	
3) Gain on repossession		_____
4) Gross profit on sale		_____
5) Gain reported (amount on line 2)	_____	
6) Plus: Repossession costs	_____	_____
7) Subtract amount on line 6 from amount on line 4		_____
8) Taxable gain (lesser of amount on line 3 or 7)		_____

Example. You sold a tract of land in January 1992 for $25,000. You accepted from the buyer a $5,000 downpayment, plus a $20,000 (9.5%) mortgage secured by the property and payable at the rate of $4,000 annually plus interest. The payments began on January 1, 1993. Your adjusted basis in the property was $19,000 and you reported the transaction as an installment sale. Your selling expenses were $1,000. You figured your gross profit as follows:

Selling price		$25,000
Minus:		
Adjusted basis	$19,000	
Selling expenses	1,000	20,000
Gross profit		$ 5,000

For this sale, the contract price equals the selling price. Therefore, the gross profit percentage is 20%. This is figured by dividing the gross profit of $5,000 by the contract price of $25,000.

In 1992, you included $1,000 in your income (20% of the $5,000 downpayment). In 1993, you reported a profit of $800 (20% of the $4,000 annual installment). In 1994, the buyer defaulted and you repossessed the property. You spent $500 in legal fees to get your property back. Your gain on the repossession is figured as follows:

Payments received ($5,000 + $4,000)	$9,000
Minus: Gain reported	1,800
Gain	$7,200

Not all of this gain is taxable. The limit on taxable gain is figured as follows:

Gross profit on original sale		$5,000
Minus:		
Gain reported	$1,800	
Repossession costs	500	2,300
Taxable gain on repossession		$2,700

Indefinite selling price. 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 that is stated as a percentage of the profits to be realized from the buyer's development of the property is an indefinite selling price.

Character of gain. The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if you did not report the sale on the installment method, the gain is ordinary income.

Basis. Your basis in the repossessed property is determined as of the date of repossession. It is the sum of:

1) Your adjusted basis in the installment obligation,
2) Your repossession costs, and
3) Your taxable gain on the repossession.

To figure your adjusted basis on the installment obligation at the time of repossession, multiply the unpaid balance by your gross profit percentage. Subtract that amount from the unpaid balance.

Worksheet. The following worksheet can be used to determine the basis of real property repossessed.

1) Unpaid balance of obligation		____
2) Minus: Unrealized profit (amount on line 1 times gross profit percentage)		____
3) Adjusted basis on date of repossession		____
4) Plus:		
Taxable gain on repossession	____	
Repossession costs	____	____
5) Basis of repossessed real property		____

Example. Assume the same facts as in the preceding example. The unpaid balance of the installment obligation (the $20,000 note) is $16,000 at the time of repossession because the buyer made a $4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, $3,200 (20% of the $16,000 still due on the note) is unrealized profit. You figure your basis in the repossessed property as follows:

Unpaid balance of obligation		$16,000
Minus: Unrealized profit		3,200
Adjusted basis on date of repossession		$12,800
Plus: Taxable gain on repossession	$2,700	
Repossession costs	500	3,200
Basis of repossessed real property		$16,000

Holding period for resales. If you resell the property you repossessed, the resale may result in a capital gain or a capital loss. To figure whether it is a long-term or a short-term gain or loss, your holding period includes the period you 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 you repossess real property under these rules, you cannot take a bad debt deduction for any part of the buyer's installment obligation. This is so even if the obligation is not fully satisfied by the repossession.

If you already took a bad debt deduction before the tax year of repossession, you are considered to have recovered the bad debt when you repossess the property. The amount of the bad debt deduction you took in the earlier year must be reported as income in the year of repossession. However, if any part of the earlier deduction did not serve to lower your tax, you do not have to report that part as income. Your adjusted basis in the installment obligation is increased by the amount you report as income as a recovery of the bad debt.

Repossessing Your Former Home

When you sell your home, you may be permitted to postpone paying tax on part or all of your gain if you acquire a replacement residence within a specified period of time. You may also be allowed to exclude some or all of your gain from income if you are age 55 or older. See Publication 523 for information on the postponement of tax and exclusion of gain on these sales.

Special rules apply if, after using one or both of these provisions for your sale, you repossess your former home and resell it. Under these rules, you do not have any gain or loss at the time of repossession. Instead, the sale and resale are combined and treated as a single transaction. You then figure your gain on the combined sale-resale, including how much of the gain you can exclude or postpone paying tax on. These special rules apply only if:

1) The resale takes place within one year of the repossession, and
2) At least some of your gain on the original sale was not taxed because you acquired a replacement home or were age 55 or older.

If you do not meet both requirements, the general rules for repossessions of real property discussed earlier under *Real Property,* apply.

Gain. To figure your gain under the special rule, first figure both the amount you realize on the combined sale-resale and your adjusted basis in the home. The difference between these two amounts is your gain on the combined sale-resale. Then figure how much of this gain you can exclude or postpone paying tax on, using the same rules that apply to any sale of your home.

Amount realized. To figure the amount you realize on the combined sale-resale of your home, add the selling price on the resale to the selling price on the original sale, and subtract:

1) Your selling expenses for both sales,
2) The part of the original installment obligation that remains unpaid at the time of repossession, and
3) Your repossession costs.

Example. You sold your home for $50,000. Two years after the sale, you repossessed your property and resold it within one year for $55,000. When you repossessed, the first buyer owed you $36,000 on the original sale, and you paid $1,000 for the repossession. Your selling expenses were $2,000 originally and $3,000 on the resale.

The amount realized on the combined sale-resale is figured as follows:

Selling price on resale		$ 55,000
Plus: Selling price on original sale		50,000
Total		$105,000
Minus:		
Selling expenses on resale	$ 3,000	
Selling expenses on original sale	$ 2,000	
Amount unpaid on note	36,000	
Repossession costs	1,000	42,000
Amount realized on sale-resale		$ 63,000

Adjusted basis. To figure your adjusted basis for the combined sale-resale, begin with your adjusted basis in the property at the time of the original sale and make any adjustments to the property for the period after repossession. You cannot adjust your basis for the period the buyer owned the property.

You may have to make two other adjustments:

1) If the buyer became further in debt to you after the original sale, and this debt was also secured by the property you repossessed, add the amount outstanding on this debt when figuring your adjusted basis. In this way, when you figure gain on the combined sale-resale, you will take

into account the full amount that is owed you.

2) If, in an earlier year, you took a bad debt deduction for any of the buyer's obligations that were secured by the property you repossess, subtract the amount of the deduction when figuring your adjusted basis. If only part of the deduction served to reduce your tax, subtract only that part.

Excluded or deferred gain on resale. If you are age 55 or older and are excluding any part of your gain for that reason, use the gain on the combined sale-resale to see how much gain you can exclude.

If you bought a replacement home and are postponing part of your gain for that reason, you must refigure both:

1) The amount of gain you can postpone, and

2) Your adjusted basis in the replacement home.

From the amount realized on the combined sale-resale, subtract any ''fixing-up'' expenses you had for either sale. The result is the adjusted selling price for the sale-resale. Compare this amount to (1) the cost of the replacement home and (2) your gain from the combined sale-resale to figure both the amount of gain you can postpone and your adjusted basis in the replacement home.

You are allowed to take into account fixing-up expenses for both the sale and resale. Publication 523 discusses fixing-up expenses.

Reporting taxable gain. If you already reported any gain from the original sale, subtract the reported amount when reporting gain from the combined sale-resale. Make any necessary adjustments on your tax return for the year of resale.

Bad debt. If you repossess your home under these rules, you cannot take a bad debt deduction for the original installment obligation, or for any other obligation that was secured by the property you repossess as a result of this reacquisition.

Reporting an Installment Sale

Use Form 6252, *Installment Sale Income,* any time you report a sale of property on the installment method. The form is used to report the sale in the year it takes place, and to report payments received in later years. In addition, if you made the sale to a related person, you may have to file the form each year until the installment debt is paid off, whether you receive a payment during the year or not.

Sales to a related person. If you sell marketable securities to a related person, complete Part III, Form 6252, for each year of the installment agreement, even if you do not receive a payment in that year.

If you sell property other than marketable securities to a related person, complete Part III for the year of sale and the 2 years following the year of sale, even if you do not receive a payment. After this 2-year period, you do not have to fill out Part III.

Later dispositions. If the related person to whom you sold your property disposes of it, you may have to immediately report the rest of your gain in Part III. See *Rule 2: Sale and Resale* under *Sales to Related Persons,* earlier, for more information.

Several assets. If you sell two or more assets in one installment sale, you may have to report the sale of each asset separately. The same is true if you sell all the assets of your business in one installment sale. See *Single Sale of Several Assets,* and *Sale of a Business,* earlier.

If you do not have too many sales to report separately, you may use a separate Form 6252 for each one. However, if you have to report separately the sales of many assets that you sold together, do not prepare a separate Form 6252 for each one. Instead prepare one Form 6252 and attach a schedule with all the information for each asset that is required by Form 6252. You would complete Form 6252 as follows:

1) Answer the questions at the top of the form.

2) In the year of sale, do not complete Part I. Instead write ''See attached schedule'' in the margin.

3) For Part II, enter the total for all the assets on lines 24, 25, and 26.

4) For Part III, answer all the questions that apply. If none of the exceptions under question 29 applies, enter the totals on lines 35, 36, and 37 for all the assets that were disposed of.

Payments past due. Do not report payments of principal you have not yet received, even if they are past due. However, if you use an accrual method of accounting, you accrue the payment due even though you have not yet received it.

Special situations. If you are reporting 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, you may not be able to provide all the information asked for on Form 6252. To the extent possible, follow the instructions given above under *Several assets,* and give as much detail as you can in a statement attached to the Form 6252.

For more information on how to complete Form 6252, see the form instructions.

Other forms. The gain from Form 6252 is carried over and entered on another form. That form may be Schedule D, *Capital Gains and Losses;* Form 4797, *Sales of Business Property;* or both. Although the references in this publication are to the Schedule D for Form 1040, the rules discussed also apply to the Schedule D's for Forms 1041 (estates and trusts), 1065 (partnerships), 1120 or 1120-A (corporations), or 1120S (S corporations). Form 4797 is used with partnership, corporation, S corporation, estate, and trust returns, as well as with individual returns.

Schedule D. If you sell property that is a capital asset and use the installment method, each year you must include the capital gain part of the installment payments from Form 6252 in your net gain or loss from the sale or exchange of capital assets. Report this gain or loss on Schedule D (Form 1040).

If your gain from an installment sale qualified for long-term capital gains treatment in the year of sale, it continues to qualify in later tax years when you receive and report the installment payments.

Form 4797. An installment sale of property used in your business or that earns you rent or royalty income sometimes results in a capital gain and sometimes in an ordinary gain and sometimes both. All or part of any gain from its disposition may be ordinary gain from depreciation. Use Form 4797 to report these transactions and to determine the amount of ordinary gain or loss and the amount of capital gain or loss.

If part of your gain on the sale is ordinary gain from depreciation (including the section 179 deduction) and part is capital gain, you must report the gain to the extent of the depreciation recapture income in the year of sale even if no payment is received.

Examples

The following examples illustrate how to fill out Form 6252. Sample filled-in forms follow these examples.

Example 1

On May 30, 1994, Tom Scout sells his home for $150,000 under terms that permit him to use the installment method. The sale agreement provides for interest payments each December at an annual rate of 8% in addition to payments on the sale price. His adjusted basis in the property is $108,000, and he has selling expenses of $9,000 for a total of $117,000. He, therefore, has a gain of $33,000 on the sale ($150,000 – $117,000). He buys another house, postponing the tax on $18,000 (line 22, Form 2119) of his gain. He figures the gross profit using only the taxable part of the gain, $15,000 ($33,000 – $18,000). His gross profit percentage is 10% ($15,000 taxable gain divided by $150,000 contract price). He reports the interest payments as ordinary income on Form 1040. He received only a downpayment of $40,000 during 1994. In addition, he received the buyer's note for $110,000 with payments to begin in 1995.

Tom fills out Form 6252 for 1994 as follows:

Question 1. Tom writes a description of the property sold.

Questions 2a and 2b. Tom enters the date he acquired the home and the date he sold it.

Question 3. Tom did not sell the home to a related party. He checks the ''No'' box.

Part I. Tom uses this part of the form to figure the contract price and his gross profit on the sale.

Line 5. Tom enters the selling price of $150,000.

Line 6. The buyer did not assume the mortgage on the home. Therefore, Tom enters nothing on this line.

Line 7. Tom enters the $150,000.

Line 8. Tom enters his basis of $108,000.

Lines 9 and 10. Tom did not take depreciation deductions on the home. The amount on line 8 carries over to line 10.

Line 11. Tom's only selling expense was a commission of $9,000, (6% of $150,000).

Line 12. Since no depreciation was claimed, Tom has no income recapture.

Line 13. The total of Tom's basis in the property plus his selling expenses is $117,000.

Line 14. Tom subtracts line 13 from line 5 and enters the result, $33,000.

Line 15. Tom enters $18,000, the part of the gain he can postpone.

Line 16. Tom subtracts line 15 from line 14 and enters the result, $15,000.

Line 17. Tom enters zero.

Line 18. The contract price, $150,000, is the sum of all payments Tom will receive on the sale.

Part II. In this part, Tom figures the amount of gain from the sale he must report for 1994.

Line 19. Tom's gross profit percentage for the sale is the gross profit on line 16 ($15,000) divided by the contract price on line 18 ($150,000) or 10%.

Line 20. Tom enters zero.

Line 21. The only payment Tom received during 1994 was the downpayment of $40,000.

Line 22. Tom enters $40,000.

Line 23. Since 1994 is the year of sale, Tom makes no entry here.

Line 24. The gross profit percentage (line 19) is 10%. Therefore, Tom enters 10% of $40,000 (line 22), or $4,000.

Lines 25 and 26. Since Tom sold undepreciated property, he does not have to recapture any depreciation deductions as ordinary income. He carries the amount on line 26 to line 12 of Schedule D (Form 1040) where it is included with other long-term capital gains.

Example 2

On November 1, 1994, Mark Moore sold a lot that he bought on February 17, 1987, for $2,650. He borrowed more on the lot than he had paid for it. At the time of the sale, $6,500 remained outstanding on these loans. In the sales contract, the buyer agreed to assume these loans and pay Mark $200 a month (plus 7% interest) for 3 years. In addition, the buyer made a downpayment of $1,000 on the sale.

Mark fills out his 1994 Form 6252 as follows:

Question 1. Mark writes in a description of the lot he sold.

Questions 2a and 2b. Mark enters the date he acquired the lot and the date he sold it.

Question 3. Because Mark sold the lot to Acme Design, a partnership of which he is a member, he checks the ''Yes'' box.

Question 4. The property Mark sold was not a marketable security (such as a stock or a bond). So he answers ''No'' to this question. Because he sold the lot to a related person, he must complete Part III of the form. But because the property he sold was not a marketable security, he must complete Part III only for 1994 and the next 2 years.

Part I. Mark uses this part of the form to figure the contract price and his gross profit on the sale.

Line 5. Mark enters the selling price, $14,700. This includes the $1,000 downpayment, the $7,200 (36 × $200) in monthly payments he is to receive, and the $6,500 in loans the buyer assumes.

Line 6. Mark enters the $6,500 the buyer assumes.

Line 7. Mark subtracts line 6 from line 5 and enters the difference, $8,200.

Line 8. Because he did not make any improvements to the lot, Mark's basis at the time of the sale was the lot's cost of $2,650.

Lines 9 and 10. Mark did not take depreciation deductions on the lot (land is never depreciable). So the amount on line 8 carries over to line 10.

Line 11. Mark's only selling expenses were $150 in legal fees. If he advertised the lot for sale or paid commission on the sale, he would include those amounts.

Line 12. Since no depreciation was claimed on the land, Mark has no income recapture.

Line 13. The total of Mark's adjusted basis in the property plus his selling expenses is $2,800.

Line 14. Mark subtracts line 13 from line 5 and enters the result, $11,900.

Line 16. The property Mark sold was not his home. So he carries the amount on line 14 to line 16. This is his gross profit on the sale.

Line 17. Mark subtracts line 13, $2,800, from line 6, $6,500. The result, $3,700, is the amount by which the assumed loans are more than his basis in the property plus selling expenses. This amount is treated as a payment in the year of sale on line 20.

Line 18. The contract price is the sum of all payments Mark will receive on the sale. This includes the downpayment and all installment payments he will receive (line 7). It also includes the ''payment'' figured on line 17.

Part II. In this part, Mark figures the amount of gain from the sale he must report for 1994.

Line 19. Mark's gross profit percentage for the sale is the gross profit on line 16, $11,900, divided by the contract price on line 18, also $11,900. It is, therefore, 100%.

Line 20. Mark carries the amount he treats as a payment on line 17 to this line, so that it will be counted with the other payments he received in the year of sale.

Line 21. At the time of the sale, Mark received a downpayment of $1,000. In December 1994, he received his first monthly installment payment. The total payment was $242, consisting of $42 interest (one month's interest on $7,200 figured at 7% a year) and $200 principal. This is the only installment payment he received in 1994. He enters the total amount paid during 1994, $1,200 ($1,000 + $200), on this line. He reports the $42 interest on Form 1040.

Line 22. Mark enters $4,900, the sum of line 20 plus line 21. This is the total of all payments he is considered to have received in 1994.

Line 23. Since 1994 is the year of sale, Mark makes no entry here.

Line 24. The gross profit percentage for this sale (line 19) is 100%. Therefore, the entire amount on line 22, $4,900, is taxable gain. Mark enters this amount on line 24.

Lines 25 and 26. Because the lot Mark sold was not depreciable property, he does not have to recapture any depreciation deductions as ordinary gain. All his gain on the sale is long-term capital gain. He carries the amount on line 26 to line 12 of Schedule D (Form 1040) where it is included with other long-term capital gains.

Part III. Because Mark sold the lot to his partnership, a ''related person,'' he must fill out this part. But because the property he sold was not a marketable security, he must complete this part only for 1994, 1995, and 1996.

Line 27. Mark enters the name, address, and employer identification number of the partnership that bought the lot.

Line 28. The partnership did not sell the lot in 1994. So Mark checks the ''No'' box. Because he checked the ''No'' box, he does not have to fill out the rest of Part III.

Example 3

In December 1993, Cora Blue sold a painting she inherited. The buyer paid her $700 down and gave her an installment note for $3,800. The note calls for quarterly payments of $530 until the $3,800 debt is paid off, in about 2 years. Each $530 payment includes interest figured at 10% a year on the outstanding debt. She received her first 4 payments on the note in 1994. The amount of principal and interest she received in each payment is given in the table below:

Payment	Interest	Principal
First	$ 95.00	$ 435.00
Second	84.13	445.87
Third	72.98	457.02
Fourth	61.55	468.45
	$313.66	$1,806.34

Cora must report the $313.66 interest as ordinary income on her Form 1040. She reports the $1,806.34 in principal on Form 6252 as follows:

Question 1. Cora states that the property she sold was an oil painting.

Questions 2a and 2b. She enters the date she acquired the painting (through inheritance) and the date she sold it.

Question 3. The buyer was not related to Cora. So she checks the ''No'' box.

Question 4. Because she checked ''No'' to question 3, Cora does not have to answer this question or fill out Part III of the form.

Part I. Cora completed Part I of her Form 6252 for the year of sale, 1993. She does not fill it out for the remaining years of the installment sale.

Part II. This is the only part of Form 6252 that Cora fills out.

Line 19. On her 1993 Form 6252, Cora figured her gross profit percentage to be 22.7%. She uses this same percentage on her 1994 Form 6252.

Line 20. Since this is not the year of sale, Cora enters zero on this line.

Line 21. Cora enters the total amount (minus interest) that she received on the sale in 1994, $1,806.34.

Line 22. The amount on line 21 carries over to line 22.

Line 23. Before 1994, Cora received only the $700 downpayment.

Line 24. Cora multiplies the gross profit percentage of 22.7% (line 19), by the amount she was paid in 1994 (line 22), $1,806.34. The result, $410.04, is the amount of gain she had on the sale in 1994.

Lines 25 and 26. Cora did not use the painting in a business. So it was not depreciable and the recapture rules do not apply. The amount on line 24 carries over to line 26. Her gain is long-term capital gain. She carries the amount on line 26 to line 12 of Schedule D (Form 1040), where it is included with other long-term capital gains.

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228

1994

Attachment Sequence No. 79

Name(s) shown on return: Tom Scout

Identifying number: 111-00-2222

1 Description of property ▶ Log cabin home

2a Date acquired (month, day, year) ▶ 10 / 6 / 79 b Date sold (month, day, year) ▶ 5 / 30 / 94

3 Was the property sold to a related party after May 14, 1980? See instructions . . . ☐ Yes ☑ No

4 If the answer to question 3 is "Yes," was the property a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale. . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. Do not include interest whether stated or unstated			5	150,000
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	6	0		
7	Subtract line 6 from line 5	7	150,000		
8	Cost or other basis of property sold	8	108,000		
9	Depreciation allowed or allowable	9	0		
10	Adjusted basis. Subtract line 9 from line 8	10	108,000		
11	Commissions and other expenses of sale	11	9,000		
12	Income recapture from Form 4797, Part III. See instructions	12	0		
13	Add lines 10, 11, and 12			13	117,000
14	Subtract line 13 from line 5. If zero or less, **stop here.** Do not complete the rest of this form			14	33,000
15	If the property described on line 1 above was your main home, enter the total of lines 14 and 22 from Form 2119. Otherwise, enter -0-			15	18,000
16	**Gross profit.** Subtract line 15 from line 14			16	15,000
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	150,000

Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	10 %
20	**For year of sale only**—Enter amount from line 17 above; otherwise, enter -0-			20	0
21	Payments received during year. See instructions. Do not include interest whether stated or unstated			21	40,000
22	Add lines 20 and 21			22	40,000
23	Payments received in prior years. See instructions. Do not include interest whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	4,000
25	Part of line 24 that is ordinary income under recapture rules. See instructions			25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	4,000

Part III Related Party Installment Sale Income. Do not 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, during this tax year, resell or dispose of the property ("second disposition")? . . . ☐ 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 only 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 (month, day, year) ▶ / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion where 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 Internal Revenue Service that tax avoidance was not 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	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 1994 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	Part of line 35 that is ordinary income under 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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Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228
1994
Attachment Sequence No. 79

Name(s) shown on return: Mark Moore
Identifying number: 222-00-3333

1 Description of property ▶ Undeveloped lot
2a Date acquired (month, day, year) ▶ 2 / 17 / 87 b Date sold (month, day, year) ▶ 11 / 1 / 94
3 Was the property sold to a related party after May 14, 1980? See instructions . . . ☒ Yes ☐ No
4 If the answer to question 3 is "Yes," was the property a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale. . . . ☐ Yes ☒ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. Do not include interest whether stated or unstated			5	14,700
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	6	6,500		
7	Subtract line 6 from line 5	7	8,200		
8	Cost or other basis of property sold	8	2,650		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	2,650		
11	Commissions and other expenses of sale	11	150		
12	Income recapture from Form 4797, Part III. See instructions	12	0		
13	Add lines 10, 11, and 12			13	2,800
14	Subtract line 13 from line 5. If zero or less, **stop here.** Do not complete the rest of this form			14	11,900
15	If the property described on line 1 above was your main home, enter the total of lines 14 and 22 from Form 2119. Otherwise, enter -0-			15	0
16	**Gross profit.** Subtract line 15 from line 14			16	11,900
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	3,700
18	**Contract price.** Add line 7 and line 17			18	11,900

Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	100 %
20	**For year of sale only**—Enter amount from line 17 above; otherwise, enter -0-			20	3,700
21	Payments received during year. See instructions. Do not include interest whether stated or unstated			21	1,200
22	Add lines 20 and 21			22	4,900
23	Payments received in prior years. See instructions. Do not include interest whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	4900
25	Part of line 24 that is ordinary income under recapture rules. See instructions			25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	4,900

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party Acme Design, W. Main Street Small Town, NY 12899 10-7654321
28 Did the related party, during this tax year, resell or dispose of the property ("second disposition")? . . . ☐ 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 only 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 (month, day, year) ▶ / /
b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
c ☐ The second disposition was an involuntary conversion where 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 Internal Revenue Service that tax avoidance was not 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	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 1994 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	Part of line 35 that is ordinary income under 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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Form **6252** | Department of the Treasury Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228 | **1994** | Attachment Sequence No. 79

Name(s) shown on return: Cora Blue | Identifying number: 045-00-0000

1 Description of property ▶ Oil painting - inheritance
2a Date acquired (month, day, year) ▶ 7/3/86 b Date sold (month, day, year) ▶ 12/11/93
3 Was the property sold to a related party after May 14, 1980? See instructions ☐ Yes ☒ No
4 If the answer to question 3 is "Yes," was the property a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale. ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. Do not include interest whether stated or unstated		
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source		
7	Subtract line 6 from line 5		
8	Cost or other basis of property sold		
9	Depreciation allowed or allowable		
10	Adjusted basis. Subtract line 9 from line 8		
11	Commissions and other expenses of sale		
12	Income recapture from Form 4797, Part III. See instructions		
13	Add lines 10, 11, and 12		
14	Subtract line 13 from line 5. If zero or less, **stop here.** Do not complete the rest of this form		
15	If the property described on line 1 above was your main home, enter the total of lines 14 and 22 from Form 2119. Otherwise, enter -0-		
16	**Gross profit.** Subtract line 15 from line 14		
17	Subtract line 13 from line 6. If zero or less, enter -0-		
18	**Contract price.** Add line 7 and line 17		

Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		22.7 %
20	**For year of sale only**—Enter amount from line 17 above; otherwise, enter -0-		0
21	Payments received during year. See instructions. Do not include interest whether stated or unstated		1806 34
22	Add lines 20 and 21		1806 34
23	Payments received in prior years. See instructions. Do not include interest whether stated or unstated	700	
24	**Installment sale income.** Multiply line 22 by line 19		410 04
25	Part of line 24 that is ordinary income under recapture rules. See instructions		
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions		410 04

Part III Related Party Installment Sale Income. Do not 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, during this tax year, resell or dispose of the property ("second disposition")? ☐ 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 only 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 (month, day, year) ▶ / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion where 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 Internal Revenue Service that tax avoidance was not 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	
31	Enter contract price from line 18 for year of first sale	
32	Enter the **smaller** of line 30 or line 31	
33	Total payments received by the end of your 1994 tax year. See instructions	
34	Subtract line 33 from line 32. If zero or less, enter -0-	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	
36	Part of line 35 that is ordinary income under recapture rules. See instructions	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	

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