A Review of Income Tax Issues Associated With Intra-Family Loans & Installment Sales Series II of IV

This paper is the second series of a four-part series exploring the following areas.

- **Part 1**: Loans and debt transactions between trusts and their beneficiaries, including the possibility of below market or interest free loans from trusts to, or for the benefit of, their beneficiaries as well as a review of IRC Section 7872, Section 483, and the so-called original issue discount ("OID") rules, primarily under IRC Sections 1272-1274 (Click here to review Part 1).

- **Part 2**: A review of the income tax rules associated with reportable installment sale transactions under IRC Section 453, including dispositions of reportable installment obligations during life, as well as the rules under Section 691 governing dispositions of reportable installment obligations as a result of death.

- **Part 3**: Post-mortem tax considerations involving loans between a grantor and their grantor trust that remain outstanding at the time of the grantor's death when the grantor trust converts to a non-grantor trust.

- **Part 4**: Loans and debt transactions between family members and non-grantor trusts or other separate taxpayers, including potential application of IRC Section 754 to step-up the inside cost basis of partnership or LLC assets if LLC or partnership interests are purchased in a taxable transaction (albeit under the installment method of reporting under IRC Section 453).

Overview

The discussion below provides a detailed summary of the installment sale rules that may be applicable to intra-family sale transactions and also reviews the application of Section 691 concerning dispositions of installment obligations by virtue of the seller's death.

IRC Section 453 Generally

Congress enacted Internal Revenue Code Section 453 to govern the income tax reporting for qualifying installment sale transactions. Installment sales must be reported under the installment method of reporting unless an exception applies or the taxpayer makes a timely election not to have the installment method apply. In general, an installment sale means any disposition of property where at least one payment is to be received after the close of the taxable year of the transaction.

Installment Method Explained & Calculation of Gross Profit Ratio

The term "installment method" means a method under which the income recognized for any tax year from a sale transaction is that proportion of the payments received in that year which the gross profit (realized or to

be realized when payment is completed) bears to the total contract price. The ratio of the gross profit realized to the total contract price is called the gross profit ratio. See the following example.

Example

A taxpayer sells qualifying installment sale assets for a contract price of $50,000 with an adjusted cost basis of $20,000. Under the terms of the installment, he will receive $30,000 in the same year and $20,000 in the following year. The gross profit on the sale will be $30,000. Under the installment method, the profit would be reported as follows:

	First Year	Second Year
Cash Recevied	$ 30,000	$ 20,000
Gross Profit Ratio ($30K/$50K)	60%	60%
Income reportable	$ 18,000	$ 12,000

In reality most installment sales will usually consist of the following three parts: (i) interest income, (ii) return of the seller's adjusted basis in the property sold, and (iii) gain on the sale. The primary effect of the installment sale rules is to cause the gain portion to be recognized ratably over the installment period. Additionally, the interest income will be reported each year as received in the case of a cash basis taxpayer.

Most intra-family installment sales are structured as interest only/balloon transactions so calculation of the gross profit percentage is not necessary from year to year. The seller will recognize and report interest income as they receive it each year but the capital gain will not be reported until the balloon year. Moreover, installment sales between grantors and grantor trusts are disregarded as non-events for income tax purposes so installment sale reporting and the various rules discussed below for those transactions are moot (at least during the grantor's lifetime).

Transactions Disqualified From Installment Sales Method

The installment sale method can't be used for the following.

- Sales of Inventory. The sale of inventory in the ordinary course doesn't qualify for installment sale treatment even if the seller receives payments after the year of sale.

- Dealer Sales. Sales of real estate to customers in the ordinary course of a trade or business do not qualify for installment sale reporting. However, the disqualification rule doesn't apply to an installment sale of property used or produced in farming.

- Publicly Traded Stock or Securities. Installment sale treatment cannot be used to report gain from the sale of stock or securities traded on an established securities market. Sellers must report the entire gain on these transactions in the year in which the trade date falls.

- Depreciation Recapture Income. If the seller sells property for which they claimed a depreciation deduction, they must report any depreciation recapture income in the year of sale, regardless of whether or not an installment payment was received that year. Taxpayers may compute their depreciation recapture income on Form 4797. The recapture income reported in the year of sale is included in the seller's installment sale

Copyright © 2024 Colony Family Offices. All Rights Reserved.

basis for purposes of calculating their gross profit ratio for the portion of the gain that exceeds the depreciation recapture income.

- Sale of Partnership Interest (With Underlying "Hot" Assets). A partner who sells a partnership interest at a gain generally is permitted to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. This is true even if the underlying partnership assets consist of publicly traded marketable securities. However, there is a "look-thru" rule that applies to prevent installment sale treatment of any gain or loss from any portion of the partnership's underlying assets that are from unrealized receivables or inventory items that would otherwise be treated as ordinary income. These are often referred to as "hot" assets.

- Certain Sales Involving Related Parties. These rules are discussed in more detail below.

- Special Rule. Dealers of timeshares and residential lots can treat certain sales as installment sales and report them under the installment method if they elect to pay a special interest charge under IRC Section 453(l).

Electing Out of Installment Sale Reporting

If the seller elects not to use the installment method, they must report the entire gain in the year of sale, even though they don't receive all the sale proceeds in that year. They would also have to report the interest income each year as received over the installment period.

- How to Elect Out. To make this election, don't report your sale on Form 6252. Instead, report it on Form 8949, Form 4797, or both.

- When to Elect Out. Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place.

- Automatic 6-month Extension. If you timely file your tax return without making the election, you can still make the election by filing an amended return within 6 months of the due date of your return (excluding extensions). Write "Filed pursuant to section 301.9100-2" at the top of the amended return and file it where the original return was filed.

- Revoking the Election. Once made, the election can be revoked only with IRS approval.

Sales of Depreciable Property Between Related Persons

If a taxpayer sells depreciable property to a related person and the sale is an installment sale, they may not report the sale using the installment method. For this purpose, the term "related person" means:

- A person and all controlled entities with respect to that person.
- A taxpayer and any trust in which such taxpayer (or taxpayer's spouse) is a beneficiary, unless that beneficiary's interest in the trust is a remote contingent interest.
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate.
- Two or more partnerships in which the same person owns, directly or indirectly, more than 50% of the capital interests or the profits interests.
- For information about which entities are controlled entities, see section 1239(c).

Copyright © 2024 Colony Family Offices. All Rights Reserved.

Sales and Later Sales By Related Persons

A special rule applies if a taxpayer sells or exchanges property with a related person on the installment method (first disposition) who then sells, exchanges, or gives away the property (second disposition) under the following circumstances.

- The related person makes the second disposition before making all payments on the first disposition.
- The related person disposes of the property within 2 years of the first disposition.

Under this rule, the taxpayer treats part or all of the amount the related person realizes from the second disposition (or the fair market value in the case of a subsequent gift) as if the first seller received it at the time of the second disposition. For purposes of this special rule, the following persons are considered related persons under IRC Section 267 and 318 (attribution rules apply):

- Members of a family, including only brothers and sisters (either whole or half), two people married to each other, ancestors, and lineal descendants.
- A partnership or estate and a partner or beneficiary.
- A trust (other than a section 401(a) employees trust) and a beneficiary.
- A trust and its grantor.
- Two corporations that are members of the same controlled group as defined in section 267(f).
- The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- A tax-exempt educational or charitable organization and a person (if an individual, including members of the individual's family) who directly or indirectly controls such an organization.
- An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
- A fiduciary of a trust and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- An S corporation and a corporation that isn't an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
- An executor and a beneficiary of an estate unless the sale is in satisfaction of a pecuniary bequest.

Section 453A – Interest Charge on Deferred Payment Sales in Excess of $5 Million

Installment sellers in some large transactions are required to pay an additional tax each year that is computed like a deemed interest charge. The deemed interest charge is intended to compensate the Treasury for the delay in the payment of the regular tax on installment gains. Generally, the additional tax applies to gain on all installment sales of a taxpayer greater than $150,000, if, at year-end, the taxpayer holds installment obligations from all sales during the year in an aggregate principal amount exceeding $5 million.

An installment sale is excepted from the additional deemed interest charge and excluded in applying the threshold if the taxpayer (1) held the property sold for personal use, or (2) used or produced the property in a trade or business of farming. Sales of timeshares and residential lots are excepted as they have their own interest charge regime.

Copyright © 2024 Colony Family Offices. All Rights Reserved.

Calculation of Interest Charge.

- First, find the underpayment rate in effect for the month in which the installment sale occurs. The underpayment rate is published quarterly in the Internal Revenue Bulletin.
- Next, compute the deferred tax liability. The deferred tax liability is equal to the balance of the unrecognized gain at the end of the tax year multiplied by the seller's maximum tax rate (ordinary or capital gain, as appropriate) in effect for the tax year. The seller will need to determine the gross profit percentage of the installment sale to calculate the amount of the gain that has not been recognized.
- Next, the seller computes the applicable percentage. The applicable percentage is the aggregate face amount of obligations outstanding as of the close of the tax year in excess of $5,000,000 divided by the aggregate face amount of obligations outstanding as of the close of the tax year.
- Last, to determine the interest charge on the deferred tax for the year, multiply the deferred tax liability by the applicable percentage by the underpayment rate.

Example of Interest Charge Calculation

Assume father sells non-depreciable real estate to son worth $6,000,000 at a time when father's tax basis is $4,000,000 for a 10 year installment promissory note with a face amount of $6,000,000. Under the terms of the promissory note, son will pay interest only at the AFR rate of 6% to father each year with a balloon payment of principal in the final year. The deferred tax liability (disregarding the Medicare surtax and state income taxes) is 20% of $2,000,000, or $400,000. If the underpayment rate published by the IRS is 8%, then the annual interest charge will equal $5,334 ($400,000 x 16.67% applicable percentage x 8%).

Section 453B - Dispositions of Installment Obligations

A disposition generally includes a sale, exchange, cancellation, gift, 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 the seller.

If the seller is utilizing the installment method and disposes of the installment obligation, generally the seller has to accelerate their gain as of the date of the disposition of the installment obligation. The gain is attributed to the sale of the property for which the installment obligation was issued. If the original installment sale produced ordinary income, the disposition of the obligation will result in ordinary income. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain.

Application of Rules Resulting From Dispositions of Installment Obligations

- If the taxpayer sells or exchanges the installment obligation, or they accept less than face value in satisfaction of the obligation, their gain is the difference between their basis in the obligation and the amount they realize.

- If the taxpayer disposes of the obligation in any other way, their gain is the difference between their basis in the obligation and its fair market value at the time of the disposition. This rule applies, for example, when the seller gives the installment obligation to someone else or cancels the buyer's debt.

- If the seller accepts part payment on the balance of the buyer's installment debt and forgives the rest of the debt, the seller must treat the settlement as a disposition of the installment obligation. The seller's gain is the difference between the seller's basis in the obligation and the amount realized by the seller on the settlement.

Copyright © 2024 Colony Family Offices. All Rights Reserved.

Transactions Not Generally Considered Dispositions of Installment Obligations.

- If the seller reduces the selling price but doesn't cancel the rest of the buyer's debt, it isn't considered a disposition of the installment obligation. The seller must refigure the gross profit percentage and apply it to payments received after the reduction.

- If the buyer sells the purchased property to someone else and the seller agrees to let the new buyer assume the original buyer's installment obligation, the seller shouldn't be considered to have disposed of the installment obligation. It isn't a disposition even if the new buyer pays the seller a higher rate of interest than the original buyer.

- No gain or loss is recognized on the transfer of an installment obligation between spouses or former spouses if the transfer is incident to a divorce. The same tax treatment of the transferred obligation applies to the transferee spouse or former spouse as would have 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 doesn't apply if the spouse or former spouse receiving the obligation is a nonresident alien.

- The transfer of an installment obligation as a result of the death of the seller isn't a disposition under Section 453B, but instead will be governed by Section 691 (discussed below).

Section 691: Dispositions of Installment Obligations Resulting From Death

If an installment seller dies holding an unpaid installment obligation that was reportable under Section 453 during life, the estate or other person receiving the obligation by reason of the seller's death essentially steps into the seller's shoes in reporting the installment gain. Generally, the transmission at death itself is not a disposition triggering gain recognition. Moreover, if the installment obligation is initially an asset of the estate but is distributed to an heir, the distribution is usually not a taxable disposition. Instead, the estate or heir applies the seller's gross profit ratio to payments received after death, and the resulting gain is reported as income in respect of a decedent, having the same character as it would have had in the decedent's hands.

Notwithstanding the above, an installment obligation is deemed transferred under Section 691(a)(5) in a taxable disposition, usually by the estate, if it is bequeathed to the obligor, distributed by the estate to the obligor, or canceled by the executor or the decedent's will or if the obligation becomes unenforceable for any other reason on the decedent's death. Moreover, if the decedent and the obligor were related persons, the amount realized as a constructive disposition equals the obligation's face amount. Thus, parallel rules are intended to apply to postmortem and lifetime transactions under Section 691 and Section 453.

In Series 3, we will dive deeper into some of the port-mortem tax considerations debated by practitioners involving installment notes between a grantor and his or her grantor trust to the extent they remain outstanding at the time of the grantor's death when the grantor trust converts to a non-grantor trust. Additionally, the next series will discuss the potential interaction (or lack thereof) of the basis step-up rules of Section 1014 with items that are considered "income in respect of a decedent" under Section 691.

Copyright © 2024 Colony Family Offices. All Rights Reserved.

Disclaimer

This material is furnished on a confidential basis to the recipient for informational purposes only and does not constitute investment, legal or tax advice and should not be used as a substitute for the advice of a professional legal or tax advisor. This presentation does not constitute an offer to sell, or a solicitation of an offer to buy, any interest in any investment vehicle, and should not be relied on as such.

Colony Family Offices does not accept any responsibility or liability arising from the use of this material. No representation or warranty, express or implied, is given or made that the information presented herein is accurate, current or complete, and such information is at all times subject to change without notice.

This presentation may not be copied, reproduced or distributed without prior written consent of Colony Family Offices. By accepting this presentation, you acknowledge that all of the information contained in this presentation shall be kept strictly confidential by you. This information is limited in scope and is not intended to provide an exhaustive analysis.

Colony Family Offices and its directors, officers, agents and employees are not permitted to render tax or legal advice. Please consult with your tax and legal advisors prior to entering into or implementing any financial transactions.

Any tax related material contained within this communication is subject to the following disclaimer required pursuant to IRS Circular 230: Any tax advice contained in this written communication is not intended to be used, and cannot be used, for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax-related matter.

Colony Family Offices is a registered investment advisor. Registration does not imply a certain level of skill or training. More information about the firm, including its investment strategies and objectives, can be found in our ADV Part 2, which is available, without charge, upon request. Our Form ADV contains information regarding our Firm’s business practices and the backgrounds of our key personnel.

CFO-24-43

Copyright © 2024 Colony Family Offices. All Rights Reserved.