



**SELECT PORTFOLIO
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White Paper

Estate Freeze Technique:

Installment Sales

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Estate Freeze Technique: *Installment Sales*

What is it?

An installment sale is a transaction in which one party sells an asset to another party. Rather than receiving the entire price at the time of the sale, the seller receives a series of payments spread out over time. To qualify for installment sales treatment, the seller must receive at least one payment in a year after the taxable year in which the sale occurred.

An installment sale transaction is similar in some respects to a private annuity. However, an installment sale is more flexible than a private annuity because the payments from buyer to seller can begin or end whenever the parties want them to. Unlike a private annuity, the payments under an installment sale do not have to continue until the death of the seller. A variation on an installment sale is the self-canceling installment note (also called the SCIN). With a SCIN, the seller takes back a note, and the buyer must make a series of payments to the seller under that note. There is a provision in the note that upon the death of the seller, the remaining payments will be canceled. The buyer should pay a premium for this self-canceling feature. With a SCIN, there are complex income and gift tax considerations, so you should consult an attorney for guidance. An installment sale can be an excellent estate freezing strategy when the sale is between family members and involves rapidly appreciating assets, such as a family business or real estate. The installment sale will freeze the value of the asset for the seller (the older generation) for estate tax purposes and allow any future appreciation in the asset to be passed to the younger generation.

When can it be used?

One payment must be made in a taxable year after year of sale

To qualify for installment sale treatment, at least one of the payments of the installment sale must be made in a taxable year after the year of the sale. There is no requirement that there be a payment in the year of the sale. The seller of the asset has a great deal of flexibility in how and when the payments will be structured.

Payments may be deferred as much or as little as seller desires

The seller of the asset may defer as much or as little of the payments as he or she desires. The seller has tremendous flexibility in setting up how much of the total sale price will be received in what year. As long as one of the payments is made in a taxable year after the year of the sale, then the seller can structure the payments in almost any fashion.

Example(s): You are 65 years old and own a successful business. You would like to retire and sell the business to your son, who has been working with you for the past ten years. You sell the business to your son for \$1,000,000 in an installment sale. In the year of the sale, you have substantial other income, putting you in the highest marginal tax bracket. You expect to be in a lower tax bracket once you retire. You can structure the installment sale so that you receive either nothing or a nominal amount in the year of the sale and then spread the remaining sale price over any number of years that you desire. The payments could continue for 5 or 10 or 15 years. You have the flexibility to design the payment plan to fit your tax and other needs.

Tip: Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005, the capital gains portion of installment payments received after May 5, 2003 and before January 1, 2011 will be taxed at the lower long-term capital gains tax rates of 15 percent for taxpayers in marginal tax brackets higher than 15 percent and 5 percent (zero in 2008-2010) for taxpayers in the 15 percent and 10 percent marginal tax brackets. Absent further legislative action, beginning in 2011, the long-term capital gains tax rates will revert to pre-2003 Tax Act levels of 20 percent for taxpayers in marginal tax brackets higher than 15 percent and 10 percent for taxpayers in the 15 percent and 10 percent marginal tax brackets. Taxpayers who are receiving such payments may want to consider accelerating payments into years before 2011.

No minimum sale price required

There is no minimum selling price necessary for an installment sale. You could set up an installment sale for even a very low-priced asset. For example, if you sold a piece of land to your daughter for \$10,000, you could structure a sale where the price is paid over ten years.

Installment sale may take place even if selling price is contingent

You may set up an installment sale for an asset even if the selling price is contingent on some other event at the time of the sale. For example, you may sell your business to your two children, and the final sale price will be contingent on how well the business does over the five years after the sale. Such a sale is still eligible for installment treatment.

Installment sale treatment is automatic unless you elect not to have it apply

Once you set up an installment sale, the Internal Revenue Service automatically treats it as an installment sale. For example, the gain on the sale will automatically be spread over the term of the installment sale instead of recognized immediately upon the sale. If you do not wish to have the transaction treated as an installment sale, then you need to affirmatively elect not to receive such treatment.

You cannot have installment sale treatment for the sale of marketable securities

You cannot have installment sale treatment for the sale of stocks or securities that are traded on established securities markets (e.g., the New York Stock Exchange, the American Stock Exchange, over-the-counter markets). If you do sell marketable securities through an installment sale, then any installment payments to be received in future years are considered to have been received in the year of the sale and will be taxed as such. In other words, you will be taxed on the full amount of the gain from the sale of marketable securities in the year of the sale, even if the payments are spread over a number of years.

Strengths

Shifts income from high tax years into low tax years

An installment sale allows you to spread the taxable gain from the sale of an asset over a number of payment installments. This allows you to defer the taxable gain from years in which you may be in a high tax bracket to years in which you may be in a lower bracket. You must include a portion of the gain from the sale in income only when you actually receive each payment. With an installment sale, you have the flexibility to shift income from high tax years into low tax years.

Example(s): You own a piece of undeveloped land with a basis of \$20,000 that is currently worth \$100,000. You are presently in a high tax bracket. You expect to retire in two years and anticipate that you will be in a lower tax bracket at that time. You would like to sell the land to your daughter this year, but you do not want to report the entire gain before you retire. One solution is to structure an installment sale. You can sell the land this year to your daughter, structuring the sale so that you will not start receiving payments until three years after the sale when you will be retired and in a lower tax bracket.

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May help reduce estate taxes

An installment sale transaction is a very effective estate freezing technique, especially when the sale is between family members and involves appreciating assets such as real estate or a closely held company. When the asset is sold for full and adequate consideration, only the present value of any unpaid installment payments is included in the seller's estate at the time of death. The value of the underlying asset is not included in the taxable estate of the seller. Any appreciation in the asset after the time of the sale has therefore been removed from the seller's estate without either gift or estate tax consequences. A further way to reduce the seller's estate is to have the seller gift back (using the \$12,000 annual gift tax exclusion) part or all of the payments that he or she receives from the buyer.

May create a market for a business

An installment sale may help an owner of a business or other type of property to sell that asset more readily. An installment sale may allow a buyer who cannot afford to purchase the asset outright to spread the purchase price over a number of years.

Example(s): You own a closely held company and would like to retire. Your son works in the business and would like to buy the company. The company has a fair market value of \$3,000,000. Your son does not have enough capital to buy the company outright. One solution is to structure an installment sale of the business so that the purchase price can be spread out over a number of years. Your son can then use the cash flow from the company to fund the payments.

Seller may retain security interest in property without jeopardizing income tax consequences

Unlike a private annuity, the seller in an installment sale transaction may retain a security interest in the property sold without jeopardizing the beneficial income tax treatment. In a private annuity, if any security interest is retained by the seller, all of the gain will be taxed at the time of the sale. However, in an installment sale, the seller may retain a security interest in the property sold and still spread the taxable gain over the term of the installment payments. In an installment sale transaction, the seller may also require that a third party (such as a bank issuing a standby letter of credit) guarantee payment in the case of default by the buyer.

Caution: The IRS and some courts have held that funds placed in an escrow account to secure the interest of the seller are considered to be constructively received and are currently taxable to the seller.

Allows flexibility and certainty about repayment plan

An installment sale allows for more flexibility and more certainty about the repayment plan than a private annuity. Unlike a private annuity, an installment sale transaction can begin and end whenever the parties desire (as long as one of the payments occurs in a taxable year after the year of the sale). The

buyer will also know exactly how long and how much the payments will be at the time of the sale (assuming that the installment payments are not contingent). With a private annuity, the buyer cannot be sure how long the seller will live and therefore how many payments will have to be made. Furthermore, with a private annuity, the amount of each payment must be actuarially determined and set at a specific amount. With an installment sale, you have some discretion in how the payments will be determined.

Example(s): You would like to sell a piece of artwork to your daughter this year. You expect to be in a very high tax bracket for the next two years. For tax reasons, you would like to defer receiving any payments until at least year three. You can accomplish this goal with an installment sale. You can sell the painting this year and, in the installment sale agreement, specify that payments will not begin until the third year. Furthermore, your daughter will know at the time of the sale exactly how many payments she will have to make.

Buyer may be able to deduct interest payments on installment sale purchase

Unlike a private annuity (where no part of the payment is deductible by the buyer), a buyer in an installment sale may be able to deduct interest payments made in connection with an installment sale. Under Section 163(h) of the Internal Revenue Code, a deduction will be allowed for interest incurred in the purchase of a qualified residence, for investment interest to the extent of investment income, and for interest on purchases allocable to a trade or business. No interest deduction will be allowed if the interest is considered personal interest.

Buyer in installment sale gets stepped-up basis in property

Unlike a gift, where the donee takes the basis (generally, the property's cost) of the donor, the buyer's basis in an installment sale is the purchase price of the property. This may be especially advantageous when the seller has a very low basis in the property and the property has appreciated dramatically. The buyer can use the new stepped-up basis for depreciation (if it is depreciable property) or for income-tax purposes on a sale (if the property is held for two years or more after the sale).

Example(s): You own a piece of land with a basis of \$50,000. You sell the land for \$150,000 to your daughter in an installment sale. Your daughter's basis in the land is now \$150,000. She holds the land for two years and then sells it for \$160,000. Her taxable gain is only \$10,000. She does not have to pay the tax on the \$100,000 gain to which you would have been subject had you sold the land outright. The gain is further amplified if your daughter is in a lower tax bracket than you are.

Seller may purchase and be the beneficiary of a life insurance policy on the buyer of the property

A seller in an installment sale may own, pay the premiums on, and be the beneficiary of a life insurance policy on the buyer of the property. The seller can therefore protect against the potential cutoff of

payments upon the premature death of the buyer. In fact, in many installment sale transactions, the amount of the payments is increased to allow the seller to purchase such a life insurance policy on the buyer.

Tradeoffs

Present value of unpaid installments included in gross estate of seller

Unlike a private annuity, the present value of the unpaid installments must be included in the gross estate of the seller. An installment sale can produce especially harsh estate tax results when the seller dies shortly after the sale. With a private annuity, the value of the property sold is not included in the taxable estate of the seller because the payments stop at the death of the seller. This is true even if the seller dies within a short period of time of the sale. However, with an installment sale, if there are unpaid installments still due at the death of the seller, then the present value of those remaining installment payments must be included in the seller's gross estate.

Example(s): You sell your business to your son-in-law in an installment sale. Under the terms of the transaction, you will receive 10 payments of \$200,000 each. You die two years later after receiving 2 payments. The present value (using IRS valuation tables) of the remaining 8 payments must be included in your taxable estate. If, however, the transaction was structured as a private annuity, then the present value of the remaining annuity payments is not included in your taxable estate.

May cause sizable portion of each payment to be considered interest income to seller if a note is used

Typically, in many installment sale transactions, the seller will take back an installment note from the buyer. Unfortunately, when a note is used, a sizable portion of each payment will be considered interest. This interest income will be fully taxable as ordinary income to the seller.

Gift tax may be due if property is sold for less than fair market value

If the fair market value (FMV) of the property sold exceeds the present value of the installment payments to be made, then the seller is considered to have made a gift to the buyer of the difference. If the difference is greater than the annual gift tax exclusion, federal gift tax may be owed. However, gift tax may be offset by your \$1 million gift tax applicable exclusion amount (formerly known as the unified credit), if it is available.

A gift tax may also be due if the interest rate on the installment note is below the applicable federal interest rates. The IRS considers the obligation to be worth less than its face value.

Your state may also impose a gift tax.

Is not allowed for sale of listed securities

The installment sale method does not apply to the sale of marketable securities. Under the Internal Revenue Code, a marketable security is defined as any stocks or securities that on the day of disposition are traded on an established securities market. All amounts received from the sale of listed securities are treated as received and taxable in the year of the sale.

Payments under installment sale may end before death of seller

Unlike a private annuity, there is no guarantee that the payments under an installment sale will continue until the death of the seller. If you are concerned about outliving the term of payments, then you should structure the sale as a private annuity.

May have adverse tax consequences for seller when property sold is subject to mortgage

In an installment sale, when the buyer takes the property subject to a mortgage, the amount of the debt in excess of the seller's basis is considered a payment to the seller in the year of the sale, and is fully taxable to the seller in that year.

Example(s): You sell a piece of property to your son. The property has an FMV of \$100,000, and your basis in the property is \$20,000. The property also has a mortgage of \$40,000. Your son buys the property subject to the mortgage (meaning he is responsible for the mortgage payments in the future). You are considered to have received a payment of \$20,000 in the year of the sale (in addition to any payments under the installment sale contract). This \$20,000 payment is fully taxable in the year of the sale.

Special rules for disposition of property between related parties may cause adverse tax consequences to seller

In an installment sale, there are special rules for the disposition of property between related parties. Related parties include brothers and sisters, spouses, ancestors and lineal descendants, and other related entities. The rules are very complicated and may cause the original seller to have unintended income tax liabilities. If an asset is sold to a related party in an installment sale transaction, and the related party disposes of the property before the original seller receives all of the installment payments, then the original seller is treated as if he or she received all of the proceeds from the second sale. The original seller is then liable for the capital gains tax on the amount that the second disposition exceeds the original seller's basis in the property. However, the gain is limited to the amount that the second disposition exceeds the selling price between the related parties. This rule only applies if the second disposition takes place within two years of the first disposition.

Example(s): You sell property to your daughter for \$100,000. Your basis in the property is \$50,000. Your daughter sells the property one year later for \$115,000. Under the second

disposition rule, you are considered to have received the \$115,000. However, your reportable gain (for tax purposes) is limited to \$15,000 (\$115,000 minus \$100,000). Furthermore, under this rule, any payments that you receive from your daughter in the future will be tax free until they equal the \$15,000 gain that you have to recognize.

How to do it

Hire competent and experienced attorney

A competent, experienced attorney should be hired to draft all the necessary legal documents to set up the installment sale. You may also want to have an experienced tax attorney or tax accountant review the transaction to make certain that you have complied with all of the relevant Internal Revenue Code sections. The Code sections governing installment sale transactions are extremely complex, and you need to be certain to comply with all of the relevant provisions. Otherwise, there may be disastrous income, gift, and estate tax consequences.

For certain types of property, an appraiser should be hired

If the fair market value of the property selected for the installment sale cannot be readily determined, then an independent, third-party appraiser should be hired to do an appraisal of the property. The amount of the installment payments should be based on the fair market value of the property sold. If the fair market value is not used, there may be estate and gift tax problems.

Buyer and seller need to select appropriate property for installment sale

The buyer and seller need to decide what property to select before undertaking the installment sale. If the sale is between family members, typically assets that have the potential to rapidly appreciate in the future will be selected. Such assets might include closely held stock, undeveloped real estate, commercial real estate, and other similar types of assets. From an estate planning standpoint, it makes sense to select assets that you think will appreciate in the future, because once the installment sale has taken place, any future appreciation in the asset will be removed from the seller's taxable estate. An installment sale is a very effective way to freeze the value of the seller's estate.

Tax considerations

Income Tax

Seller's income tax liability on gain may be spread over term of installment payments

One of the main tax benefits to an installment sale is that the seller may spread the taxable gain over the term of the installment payments. For income tax purposes, each payment will be broken into three parts: (1) a tax-free return of the seller's investment, (2) taxable profit, and (3) taxable interest income. To determine what part of each payment will be a taxable gain, you must determine the gross profit

ratio. This is the proportion that the gross profit (selling price minus seller's adjusted basis) bears to the total contract price (amount to be received by seller). Any interest received is separated and taxed as ordinary income.

Example(s): You sell a piece of land to your daughter for \$200,000. Your adjusted basis in the land is \$100,000. You arrange an installment sale where you will receive \$20,000 per year for ten years. The gross profit is \$100,000 (\$200,000 selling price minus \$100,000 adjusted basis). The gross profit ratio is 50 percent (\$100,000 gross profit divided by the \$200,000 to be received over the life of the installment payments). Therefore, 50 percent of each payment will be a tax-free return of investment, and 50 percent will either be capital gains or ordinary income, depending on whether the property sold was a capital asset or not. (For the sake of simplicity, interest has been ignored in this example.)

Interest portion of each payment, whether stated or imputed, will be taxed as ordinary income

The interest portion of each payment is segregated from the principal portion and then taxed as ordinary income. If the interest rate is stated in the contract and is not a below-market rate, the actual interest charged will be taxed as ordinary income to the seller and potentially deductible by the buyer. Often, the installment sale agreement will not specify an interest rate or will have a below-market interest rate. In this case, the tax code imputes interest on each payment using a statutory rate of interest, and compounds the interest semi-annually. A portion of the payment will then be treated as interest to both the seller and buyer. The interest portion of each payment is taxed as ordinary income to the seller, and the buyer may be able to deduct the interest payments (subject to the same restrictions and limitations on deductibility that apply to all interest payments). The remaining portion of the payment is considered principal, and the gross profit ratio is applied to this portion of the payment to determine what percentage is a tax-free return of investment and what portion is either a capital gain or ordinary income.

Example(s): You sell land to your neighbor for \$100,000. Your adjusted basis in the land is \$25,000. You set up an installment sale agreement where you will receive ten annual payments of \$10,000. There is no mention in the agreement about interest on the unpaid balance. The IRS will impute a statutory rate of interest to the balance and compound it twice a year. Let's assume that \$1,000 of the \$10,000 annual payment is determined by the IRS to be interest. The seller must then report this \$1,000 each year as ordinary income. The gross profit ratio (75 percent in this instance--\$75,000 divided by \$100,000) is next applied to the remaining \$9,000 principal payment. This 75 percent of \$9,000 (or \$6,750) is considered either a capital gain or ordinary income, and 25 percent (or \$2,250) is considered a tax-free return of investment.

Buyer may be able to deduct interest portion of installment payments

In general, the interest portion of the installment payment is not deductible by the buyer if the interest is considered personal. Interest is deductible by the buyer if the debt is properly allocated to (1)

investment activities, but only to the extent of investment income, (2) the conduct of a trade or business, and (3) purchase of a qualified residence.

Caution: Your tax advisor should be consulted before you deduct the interest payments on an installment sale. The rules allowing interest deductions are very complex.

Example(s): You buy your parents' house from them on an installment sale basis. You intend to use the house as your principal residence. The installment sale agreement sets an interest rate on the unpaid balance that is equal to the going market rate for fixed-rate mortgages. You will be able to deduct the interest portion of each installment payment from your income (as long as the acquisition indebtedness does not exceed \$1,000,000) because the debt is allocable to the purchase of a qualified residence.

If sale results in loss, installment sale treatment does not apply

If the sale transaction results in a loss for the seller, then the seller cannot use the installment sale method to spread the loss over the term of the installment payments. The full loss deduction must be taken in the year of the sale.

Example(s): You own a piece of land with a basis of \$100,000. Land prices in the area have been falling in recent years. You sell the land for \$60,000 in an installment sale for ten annual payments of \$6,000. You are not allowed to spread the \$40,000 loss over the ten-year term of the installment sale. Rather, the entire \$40,000 loss must be deducted in the year of the sale.

Installment sale treatment does not apply to sale of listed securities

Installment sale treatment is not available for the sale of securities that are traded on established securities markets (e.g., the New York Stock Exchange, the American Stock Exchange, over-the-counter markets). The entire gain from the sale of the securities must be recognized in the year of the sale.

Example(s): You sell \$100,000 worth of IBM stock to your grandson in an installment sale. Your basis is \$30,000, and the \$100,000 will be paid in ten installments of \$10,000 each. Your entire gain of \$70,000 must be reported in the year of the sale. You are not allowed to spread the gain over the term of the installment payments.

Installment sale treatment not allowed for depreciation recapture of real or personal property

If you sell any personal or real property that you have depreciated, recapture of that depreciation up to the amount of your gain must be recognized by you in the year of the sale, even if other gain on the sale is spread out over the term of the installment payments. The amount that is recaptured and reported as taxable income in the year of the sale may be added to the basis of the property. Thus, the gain that will have to be reported each year will be reduced.

Example(s): You sell a building to another person for \$100,000, to be paid in four annual installments. Your original basis for the building was \$120,000, but you have taken \$40,000 in depreciation deductions over the years, bringing your adjusted basis down to \$80,000. You have a gain of \$20,000 (\$100,000 selling price minus your adjusted basis of \$80,000). You could normally spread this gain out over the four years of the installment payments. However, you must recapture your depreciation up to the amount of your gain. Therefore, the entire gain of \$20,000 must be reported in the year of the sale. This reported gain of \$20,000 may then be added to your adjusted basis of \$80,000, bringing your basis up to \$100,000. Because your new basis now equals the sale price, there is no gain, and you do not have to report any taxable gain from the four installment payments. If you had sold the property for \$150,000, the entire depreciation recapture amount of \$40,000 would have to be reported in the year of the sale. The remaining gain of the \$30,000 could then be spread out over the four installment payments.

Installment sale treatment not allowed for sale of depreciable property to certain controlled entities

Installment sale treatment is not allowed for the sale of depreciable property to a controlled entity. A controlled entity includes a partnership or corporation in which you have more than a 50 percent ownership interest. A controlled entity may also be a trust in which you or your spouse is a beneficiary. All payments to be received (even if set up as an installment plan) are considered, for tax purposes, to be received in the year of the sale. This tax result is true even if you have not depreciated the property. As long as the property is eligible to be depreciated, then the entire gain must be reported in the year of the sale.

Example(s): You sell personal tangible property to a corporation in which you are an 80 percent owner. The sale price is \$50,000, and your basis is \$10,000. The property is eligible to be depreciated. The corporation buys the property on an installment plan, paying \$10,000 a year for five years. For tax purposes, you have to report the entire \$40,000 gain in the year of the sale. You have sold depreciable property to a controlled entity.

Estate Tax

Present value of installment payments still due must be included in gross estate of deceased seller

Unlike a private annuity, the present value of any installments still outstanding at the time of the death of the seller of the property must be included in the seller's gross estate. In an installment sale, the buyer must continue to make the payments even if the seller dies before the end of the installment payments. The decedent must include the present value of these post-mortem payments in his or her gross estate. However, the installment sale can still be a valuable estate-freezing tool because the property itself and any future appreciation in the property are removed from the seller's estate.

Example(s): You have sold a piece of property to your daughter in an installment sale for \$500,000. The original sale agreement calls for your daughter to make ten annual payments of \$50,000 each. After five payments have been made, you die. The present value of the five remaining payments is included in your gross estate. Your daughter must continue to make the payments to your estate or the recipient of the installment note. However, the value of the property and any appreciation in that property are not included in your gross estate. If the property was worth \$700,000 at the time of your death, you have removed this \$200,000 of appreciation from your gross estate. The installment sale can therefore be a very effective estate freezing technique. A further tip is that you can use the annual exclusion gift to return part of each payment back to your daughter, gift-tax free.

Upon death of seller, remaining payments must be reported by beneficiary as income in respect of a decedent

Upon the death of the seller of the property, the beneficiary who received the installment note from the seller must report the remaining payments in the same manner as the seller did during life. In other words, the beneficiary must divide each payment that is received into a tax-free return of investment, gain, and taxable interest. The beneficiary will be allowed an income tax deduction to the extent that the seller's estate was liable for any estate taxes on the unpaid installments.

Gift Tax

Gift tax liability may arise if property is sold for less than fair market value

When property is sold for less than its fair market value, the difference between the fair market value (FMV) and the consideration received may be a gift from the seller to the buyer. In an installment sale transaction, if the present value of the installment payments is less than the FMV of the property sold, then the seller is considered to have made a gift of the difference to the buyer. The seller will incur gift tax on this difference, which will be currently due and payable if the applicable exclusion amount has been fully utilized.

Caution: Because the FMV of the property should be the selling price, you should hire an experienced, objective appraiser to value any property for which there may be a question about the true value.

Example(s): You sell a piece of property with a fair market value of \$100,000 to your son in an installment sale. The present value of the installment payments that your son will make to you is only \$70,000. You have made a gift to your son of the \$30,000 difference.

Installment payments with low interest rates may trigger gift tax liability

If the installment payments carry a very low interest rate, this may trigger gift tax liability because the present value of the payments will be worth less than the face value of those payments. The IRS considers the difference to be a gift from the seller to the buyer (the buyer is paying less than what he

or she would with a fair market rate of interest). Unfortunately, it is not clear at the present time what interest rate should be charged to avoid gift tax consequences. You could use the prevailing market rate, the applicable federal rate, the rate for sales of farm land under \$500,000, or the rates that are imputed for income-tax purposes on installment sales. There is a split between the IRS, the tax court, and some appellate courts as to which rates should be used. You should consult your tax advisor before you set up an installment sale. You should be aware, though, that if you use a very low interest rate, you might run into gift tax problems.

Example(s): You sell a commercial building to your daughter in an installment sale. The installment agreement states that the interest rate on the unpaid balance will be 2 percent. The prevailing market rate is 7 percent, and the applicable federal rate and other rates are all well above 2 percent. Under this transaction, the IRS may consider this installment sale to be a partial gift from you to your daughter because of the low interest rate. Consequently, you may owe a gift tax.

Transaction structured as installment sale may be disregarded by IRS and treated as a gift

The IRS may treat an installment sale as an outright gift if it believes that the transaction lacks substance. The IRS is especially suspicious of intrafamily transfers where the seller takes back notes from the buyer (usually the child of the seller) but the seller has no intention of enforcing the notes. The IRS treats this type of transaction as an outright gift to the child, and the seller may owe a gift tax on the fair market value of the property transferred. You should therefore be very careful to structure the sale with valid, enforceable, interest-bearing notes to avoid nullification by the IRS.

In community property states, both spouses should join in conveyance of real property

In a community property state, if the real property that is being transferred in an installment sale is community property, then both spouses must join in the conveyance of the community real property. If the real property is held in the name of one spouse only and that spouse tries to transfer the property without the consent of the other spouse, then the other spouse has the right to void the sale in certain community property states. If the community property is held in both spouses' names, then the transfer by one spouse will be void only with respect to the interest of the other spouse. Therefore, you should be very careful when structuring an installment sale in a community property state.

One community property owner may sell interest as an installment sale while other owner sells interest outright

In a community property state, it's possible that each person may separately sell his or her interest in community property. One spouse, for example, may sell his or her interest outright and would then have to recognize his or her entire gain in the year of the sale. The other spouse could sell his or her interest in an installment sale and spread the gain over the term of the installment payments. There may be situations where this strategy would make tax sense.

Unmarried partners may have joint property rights similar to community property states

Some recent court decisions have found that there may be implied agreements between unmarried individuals to treat their property similar to that of community property states. You should therefore be cautious when purchasing property from an individual involved in such a relationship. It is possible that the other person may be able to void the entire sale or at least void the sale with respect to his or her interest in the joint property. You may want to get the other person to transfer his or her interest as well.

Questions & Answers

How can life insurance be used to enhance an installment sale transaction?

There are several ways that life insurance can be used to enhance an installment sale transaction. First, a seller who is relying on the buyer to make a series of installment payments over time may be in trouble if the buyer dies before all the payments have been made. In an installment sale, the seller may purchase life insurance on the life of the buyer to give the seller some protection in the case of premature death of the buyer. The seller can be both the owner and beneficiary of the policy and can also make the premium payments. In addition, the installment payments made by the buyer could be increased to cover the seller's cost of purchasing the life insurance policy. Second, the buyer may want to purchase insurance on his or her own life. The value of the property bought and all post-sale appreciation in the property will be included in the taxable estate of the buyer. His estate may need additional liquidity to pay the estate taxes at the time of his death. Third, the buyer's family may want to purchase insurance on the life of the buyer (payable to the buyer's estate) to assure the family members that there will be enough liquidity in the buyer's estate to continue making the installment payments to the seller. It is important to remember that even if the buyer dies before the installment payments have been completed, the buyer's estate is typically responsible for making the remaining payments.

Are there any special requirements for a self-canceling installment note?

A SCIN is simply a note that has a provision in it that any payments remaining at the time of death of the holder are automatically canceled. All of the tax rules that apply to installment sales also apply to SCINs. However, there are additional tax rules applicable to a SCIN. Section 453B of the Internal Revenue Code holds that the cancellation of an installment note is considered a taxable disposition of the note. The gain would then have to be reported by the estate as income in respect of a decedent. For gift tax purposes, because the seller may die before all of the notes are due, the potential benefit to the buyer is increased (he may not have to make all the payments). Therefore, if the selling price is not increased, the seller is considered to have made a gift to the buyer and a gift tax may be due. If the selling price is increased to avoid the gift tax problem, then the seller will have to report a larger gain on the initial sale than if there were no self-canceling feature. Finally, because the balance of the note is canceled at the death of the seller, the tax court has held that there is nothing to include in the decedent's estate.

Example(s): You sell all the stock in your closely held business to your daughter. You receive a small cash down payment from your daughter and take back a 10-year installment note for the remainder of the purchase price. The sales agreement and the installment note both provide that all sums due on the note will be automatically extinguished and canceled at your death. The terms of the sale include a risk premium to compensate you for the possible cancellation of the note. You die six years later. At the time of your death, the unrecognized installment sale income is \$25,000 (your death cancels the installment obligations under the note with five years of payments still to be made). No portion of the note receivable has to be included in your gross estate.

How can sellers increase their security in an installment sale?

In an installment sale, there are various ways for sellers to make sure that they will receive all of the payments due to them under the installment agreement without being taxed on the entire gain in the year of the sale. First, as discussed in question one, the seller may purchase insurance on the life of the buyer to protect himself or herself against the premature death of the buyer. Second, a third party may guarantee that the payments will be made if the buyer defaults. The seller may have the buyer arrange a standby letter of credit from a bank to secure the installment payments. Third, the seller may have the buyer place funds into an escrow account to secure the payments. If the parties set up an escrow account, they must be very careful in doing so. The IRS typically deems funds placed into an escrow account to be constructively received by the seller and thus fully taxable in the year of the sale. The seller may succeed, though, if he or she can show that there is a legitimate business purpose for the escrow account and that he or she will continue to look to the contractual obligation of the buyer for payment.

Can you do an installment sale if the selling price is contingent on some future event?

Yes, installment sale treatment is possible even if the selling price at the time of the sale is not precisely known. It is very common in the sale of many types of property that the final sale price will depend on some future contingency not known at the time of the sale. For example, you may sell a closely held corporation in an installment sale to one of your employees where the annual installment payments will be a percentage of the yearly profits of the company. Installment sale treatment is available even in this situation. The formulas to determine what percent of each payment received by the seller should be a tax-free return of basis and what percent should be a taxable gain are fairly complicated. Under one method, you estimate the maximum potential gross profit from the sale and then divide that by the maximum potential total selling price. This ratio is then multiplied by the installment payment to determine the percentage of each payment that will be a taxable gain. If it later appears that the maximum outcome will not occur, then adjustments can be made to the remaining payments to reimburse you for your tax overpayments. If the sale price cannot be determined but there is a fixed number of payments that can be made, the basis is spread ratably over the fixed number of payments.

Caution: The tax treatment of installment sales with contingent payments can be extremely complex. Your tax advisor and accountant should be consulted before you try to set up an installment sale transaction where the sale price is contingent on some future event.

What are the tax consequences when the seller forgives the buyer's obligation to make payments?

The IRS treats the cancellation of the buyer's obligation to continue to make payments as a disposition, and the seller must report either a gain or a loss. The gain or loss is measured by the difference between the fair market value (FMV) of the obligation and the basis. The seller may also be liable for a gift tax on the transaction. If the transaction is between related parties, then the IRS considers the FMV of the obligation to be not less than the face value.

Example(s): You sell a piece of property to your son for \$200,000 in an installment sale. The sale price will be paid in 10 installments of \$20,000 each. Your basis is \$50,000. You immediately cancel your son's obligation to make payments. You must report a taxable gain of \$150,000. In addition, you may have to pay gift taxes.

One solution in the above example to avoid the imposition of the gift tax is to simply forgive enough of the annual payments each year (assuming you do not cancel your son's obligation) to fully make use of the annual gift tax exclusion each year. In this manner, you could forgive up to \$12,000 worth of installment payments and not pay any federal gift tax (you may still owe state gift tax). If you split the gift with your spouse, and you are both U.S. citizens and make the gift jointly, then you could forgive up to \$24,000 worth of installment payments and not be liable for any gift tax. See Split Gifts. However, the IRS may question whether the transaction qualifies as a sale, as opposed to a gift in the year of the original transfer, where there appears to be a plan to cancel the installments due.

When would a seller want to forego the installment sale method of reporting a gain for tax purposes, even if the sale was done on an installment basis?

There are times when it may make sense to report the entire gain from a sale in the year of the sale, even though the proceeds will be received over time through a series of installment payments. For example, if you have other unrelated losses in a particular year against which you can write off the gains, it may be smart tax-wise to take all of the gain in the year of the sale. Also, if you have a year where your income is unusually low (and you expect to be in a lower income tax bracket), you probably will be better off to take all of the gain from the installment sale in that year. Similarly, if you have a year in which you have unusually large deductions, you may want to offset the entire gain against those deductions.

Caution: For tax purposes, installment sale treatment is automatic (for a qualifying sale). If you want to report the entire gain in one year, you have to report the gain in your gross income for that year. When you have decided to report all of the gain in one year, then you can revoke this election only under very limited circumstances.

Does the seller have to receive a payment in the year of the sale to qualify for installment sale treatment?

No. The seller does not have to receive a payment in the year of the sale. The only requirement is that at least one payment be received in a taxable year other than the year of the sale. In fact, the buyer and seller have tremendous flexibility in how they structure the payment schedule. For example, they could wait five years before the payments begin. Similarly, the buyer and seller have flexibility in determining the size of each payment (for example, more money could be paid in one year than in another year).

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