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WEALTH STRATEGIES & INSURANCE SOLUTIONS, INC.

Installment Sale

Overview

An Installment Sale is a method for extending the payment period (and thus any income tax consequences) upon the sale of property. The purchase price is paid by the buyer in installments over a period of years. An installment sale may be appropriate when the asset owner wants to sell property to a buyer who does not have the funds to purchase the property outright, or when a seller is in a high income tax bracket and does not wish to be taxed on the sale in a single tax year.

Variations of the Installment Sale technique include a Self-Canceling Installment Note (SCIN), Private Annuity, and a Sale to an Intentionally Defective Irrevocable Trust (IDIT).

- A SCIN is a traditional installment sale with an added cancellation feature that triggers at the seller's death. If the seller dies with a remaining obligation left on the note, the debt is extinguished. A SCIN may be appropriate in a family situation if the seller has a shorter than average life expectancy.
- A Private Annuity is an arrangement in which an individual (annuitant) transfers property to a second party (obligor) in exchange for a lifetime income stream that is the actuarial equivalent of the value of the property. Like a SCIN, a Private Annuity can be a useful tool to transfer assets if the seller has a shorter than average life expectancy, especially if the annuitant's medical condition makes other estate planning tools or life insurance impractical. Although Private Annuities were once popular, changes to the tax law have significantly reduced its tax advantages.
- A Sale to an IDIT is much like a standard Installment Sale, but property is sold and held within a trust where income tax consequences are attributed to the grantor.

Description and Operation

Installment Sale

Generally, the seller and buyer negotiate the terms of sale, which may include the purchase price, interest rate, duration of the installment note, and other payment provisions. Once the terms are negotiated, the seller and buyer enter into an installment sale agreement, and the seller sells the property to the buyer in exchange for a promissory note. The note can be structured to require lower payments in the early years, thus reducing the cash flow requirements if the transferred property is expected to have greater cash flow in

the future. The note typically bears interest at the applicable Federal Rate (AFR) in effect when the note is executed, based on duration. These rates are issued by the Internal Revenue Service (IRS) on a monthly basis. In months where the AFR is low, the grantor has the ability to lock in a low rate for the duration of the payout period. In the event of the grantor's death while the note remains outstanding, the note would be included in the grantor's estate. Any appreciation in the value of the asset is excluded from the grantor's estate for estate tax purposes.

Self-Cancelling Installment Note (SCIN)

With a traditional installment sale, the balance left unpaid at the seller's death is included in the taxable estate. In contrast, a SCIN is designed to remove from the estate the balance of the note remaining at death. This is accomplished through a bargained-for provision in the note, under which all installment obligations automatically cease upon the earlier of full satisfaction of the note or the date of the seller's death. Thus, a SCIN not only freezes the estate tax value of the asset sold, but also removes part of the value from the seller's estate if the seller dies before the note is entirely paid.

To account for the possibility that the seller's life could end prior to full payment, a SCIN must contain a "risk premium"—i.e., an addition to either the purchase price or the interest rate. Although there is no specific guidance on how to determine the risk premium, typically, the current interest rates and the seller's life expectancy are factors which should be considered. If the SCIN duration exceeds the seller's life expectancy, it will be considered a private annuity, which does not allow for interest deductions.

Private Annuity

In a Private Annuity sale, the purchase price is generally an annuity based on the life of the seller. In exchange for the property, the obligor must make annuity payments for the seller's lifetime. Even if the annuitant lives past his/her life expectancy, the obligor is still required to pay the annuitant an income stream. Upon the annuitant's death, the property is normally not included in the annuitant's taxable estate.

Sale to an Intentionally Defective Irrevocable Trust (IDIT)

An IDIT is an irrevocable trust established by a grantor generally for the benefit of the grantor's family. An IDIT is drafted such that the trust income is taxed to someone other than the trust or beneficiaries. Basically, the grantor (or some other person) is considered the owner of the trust for income tax purposes. Unlike a traditional Installment Sale where an individual or an entity purchases the property, under a Sale to an IDIT, the trust would be the buyer. Generally a Sale to an IDIT works much the same way as a traditional Installment Sale; however, the grantor may also make a "seed gift" to the trust in order to avoid a potential IRS argument that a subsequent sale to the trust is a gift with a retained interest. The seed gift is typically valued at 10% of total trust assets after the sale. The grantor can utilize a portion of his or her lifetime gift tax exemption amount or annual exclusion gifts to avoid gift tax. The grantor can then sell the desired property to the trust, and the trust would issue a promissory note for the purchase price.

Tax Implications

Income Tax Considerations

- **Installment Sale General.** Generally, the seller will pay income tax only as payments are received. In a standard Installment Sale of a capital asset (such as real estate, stock, etc.), each payment consists of:
  - Return of cost basis (non-deductible to the buyer and non-taxable to the seller);
  - Capital gain (non-deductible to the buyer and generating capital gain rates—often long-term—to the seller); and interest (possibly deductible to the buyer as business or investment interest, and generating ordinary income to the seller).

However, the IRS may charge interest on the deferred tax on an installment note where both (i) the purchase price exceeds $150,000 and (ii) the outstanding balance exceeds $5,000,000.

Losses incurred on sales between related parties are not deductible. However, if the buyer later re-sells the property at a gain, the previously disallowed loss may offset any appreciation. Installment sales between family members can be an effective estate freezing technique when the subject property is appreciating rapidly. Appreciation subsequent to the sale can be shifted from the seller's estate to that of a younger generation member.

- **SCINs.** While SCINs are taxed much like a standard Installment Sale, transferring appreciated property has a drawback. The seller's premature death is deemed a "disposition" of the note. As such, any unpaid gain remaining at the seller's death is income taxed at the capital gains rate.

- **Private Annuities**. At one point, Private Annuities were a fairly popular planning technique because, like an Installment Sale, gain was deferred until payments were received. However, the IRS has issued proposed regulations that are effective for sales after October 18, 2006. Those regulations provide that the entire gain or loss would be recognized at the time of the transaction. Gain would be calculated by subtracting the seller's cost basis from the present value of the annuity. The tax result would be as if the seller sold the property, then purchased an annuity with the sale proceeds.

  Unlike an Installment Sale, in a Private Annuity arrangement, the "interest" portion is not deductible by the obligor. If the property is sold before the annuitant's death, the obligor's basis for gain is the total payments actually made plus the actuarial value of future payments as of the date of sale. The obligor's basis for loss is the total amount of payments made as of the date of sale. If the property is sold after the annuitant's death, the obligor's basis for gain or loss is the total of annuity payments made, less any depreciation taken.

- **Sale to an IDIT.** As mentioned above, for a Sale to an IDIT, income tax consequences are attributed to the grantor.

Gift Tax Considerations

If the transaction represents a bargained-for bona-fide sale, and the purchase price, interest rate, and duration are reasonable when the sale is transacted, no gift should be triggered.

Estate Tax Considerations

For a standard Installment Sale and Sale to an IDIT, any unpaid balance will be included in the seller's taxable estate. Conversely under a SCIN, the cancelled note should not be included in the estate of the seller. Similarly for a Private Annuity, the original property sold will not be includible in the annuitant's taxable estate.

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