Installment Sale

Essentials 2018

An installment sale allows the seller to defer part of the capital gain to future taxation years. Installment notes require the buyer to make regular payments (installments) on a periodic basis. Interest must be charged if installment payments are to be made in subsequent taxable years.

How an Installment Sale Works

1. Client sells asset to buyer. The note bears an interest rate at least equal to the applicable federal rate based on the term of the note plus a risk premium.
2. Buyer receives the asset(s) and agrees to make installment payments to seller.
3. Seller receives payments and reports gain spread over the term of the note.
4. If seller dies before the final payment, the note may or may not become immediately due, depending on the contractual language.
5. If buyer dies before the final payment, the buyer's estate must continue making payments until note is satisfied.

A life insurance policy on the buyer can cover the risk of non-payment if the buyer dies. Life insurance may also be used to fund an accelerated buyout at the death of the seller.

Considerations

- The seller will recognize gain over the term of years unless the seller elects to recognize all of the gain in the year of the sale. The installment sale rules are very complex.
- An installment note is a type of promissory note setting out the principal and interest payments of the installment sale, as well as the schedule for payments.
- The note must bear an adequate rate of interest based on the note's duration – using the applicable federal rate (short-term, mid-term, or long-term).

Essentially

Installment sales allow sellers to defer taxation on sales when the payment is received in two or more years.

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