Installment Sale – a Useful Tool to Minimize Taxes

Selling a property one has owned for a long period of time will frequently result in a large capital gain, and reporting all of the gain in one year will generally expose the gain to higher than normal capital gains rates and subject the gain to the 3.8% surtax on net investment income added by Obamacare.

Capital gains rates: Long-term capital gains can be taxed at 0%, 15%, or 20% depending upon the taxpayer's regular tax bracket for the year. At the low end, if your regular tax bracket is 15% or less, the capital gains rate is zero. If your regular tax bracket is 25% to 35%, then the top capital gains rate is 15%. However, if your regular tax bracket is 39.6%, the capital gains rate is 20%. As you can see, larger gains push the taxpayer into higher capital gains rates.

Surtax on net investment income – Tax law treats capital gains (other than those derived from a trade or business) as investment income upon which higher-income taxpayers are subject to a 3.8% surtax on net investment income. A large gain generally pushes a taxpayer's income over the threshold for this tax. For individuals, the surtax is 3.8% of the lesser of (1) the taxpayer's net investment income or (2) the excess of the taxpayer's modified adjusted gross income (MAGI) over the threshold amount for his or her filing status. The threshold amounts are:

- $125,000 for married taxpayers filing separately.
- $200,000 for taxpayers filing as single or head of household.
- $250,000 for married taxpayers filing jointly or as a surviving spouse.

This is where an installment sale could fend off these additional taxes by spreading the income over multiple years.

Here is how it works. If you sell your property for a reasonable down payment and carry the note on the property yourself, you only pay income taxes on the portion of the down payment (and any other principal payments received in the year of sale) that represents taxable gain. You can then collect interest on the note balance at rates near what a bank charges. For a sale to qualify as an installment sale, at least one payment must be received after the year in which the sale occurs. Installment sales are most frequently used when the property that is sold is real estate, and cannot be used to report the sale of publicly traded stock or securities.

> ***Example:*** *You own a lot for which you originally paid $10,000. You paid it off some time ago, leaving you with no outstanding mortgage on the lot. You sell the property for $300,000 with 20% down and carry a $240,000 first trust deed at 3% interest using the installment sale method. No additional payment is received in the year of sale. The sales costs are $9,000.*

Computation of Gain

Sale Price	$300,000
Cost	< $10,000>
Sales costs	< $9,000>
Net Profit	$281,000

Profit % = $281,000/$300,000 = 93.67%

Of your $60,000 down payment, $9,000 went to pay the selling costs, leaving you with $51,000 cash. The 20% down payment is 93.67% taxable, making $56,202 ($60,000 x .9367) taxable the first year. The amount of principal received and reported each subsequent year will be based upon the terms of the installment agreement. In addition, the interest payments on the note are taxable and also subject to the investment surtax.

Thus in the example, by using the installment method the income for the year was reduced by $224,798 ($281,000 – $56,202). How that helps the taxpayer's overall tax liability depends on the taxpayer's other income and circumstances.

Here are some additional considerations when contemplating an installment sale.

Existing mortgages – If the property you are considering selling is currently mortgaged, that mortgage would need to be paid off during the sale. Even if you do not have the financial resources available to pay off the existing loan, there might be ways to work out an installment sale by taking a secondary lending position or wrapping the existing loan into the new loan.

Tying up your funds – Tying up your funds into a mortgage may not fit your long-term financial plans, even though you might receive a higher return on your investment and potentially avoid a higher tax rate and the net investment income surtax. Shorter periods can be obtained by establishing a note due date that is shorter than the amortization period. For example, the note may be amortized over 30 years, which produces a lower payment for the buyer but becomes due and payable in 5 years. However, a large lump sum payment at the end of the 5 years could cause the higher tax rate and surtax to apply to the seller in that year – so close attention needs to be paid to the tax consequences when structuring the installment agreement.

Early payoff of the note – The buyer of your property may decide to pay off the installment note early or sell the property, in which case your installment plan would be defeated and the balance of the taxable portion would be taxable in the year the note is paid off early or the property is sold, unless the new buyer assumes the note.

Tax law changes – Income from an installment sale is taxable under the laws in effect when the installment payments are received. If the tax laws are changed, the tax on the installment income could increase or decrease. Based on recent history, it would probably increase.

Installment sales do not always work in all situations. To determine whether an installment sale will fit your particular needs and set of circumstances, please contact this office for assistance.