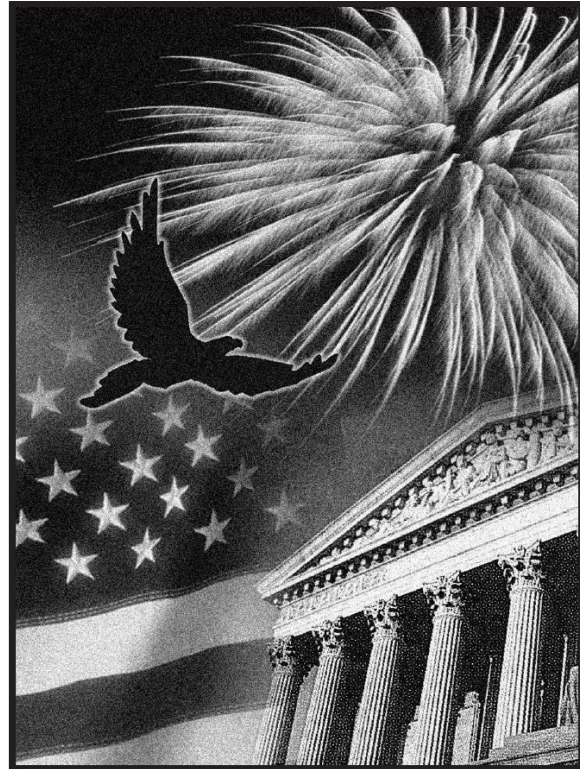


Publication 537

Installment Sales

For use in preparing **2023** Returns

Volume 1 of 2



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Department of the Treasury
Internal Revenue Service

Publication 537 (Rev. 2023) Catalog Number 39288G
Department of the Treasury **Internal Revenue Service** www.irs.gov



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Future Developments

For the latest information about developments related to Pub. 537, such as legislation enacted after it was published, go to [IRS.gov/Pub537](https://www.irs.gov/pub537).

Reminders

Reporting form for Qualified Opportunity Fund (QOF) investments. Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, is used to report holdings, deferred gains, and dispositions of QOF investments. See the instructions for Form 8997 for more information.

Like-kind exchanges. Beginning after December 31, 2017, section 1031 like-kind exchange treatment applies only to exchanges of real property held for use in a trade or business or for investment, other

than real property held primarily for sale. See [*Like-Kind Exchange*](#), later.

Photographs of missing children. The IRS is a proud partner with the [*National Center for Missing & Exploited Children® \(NCMEC\)*](#).

Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

Note. Section references within this publication are to the Internal Revenue Code, and regulation references are to the Income Tax Regulations.

Installment sale. An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If

you realize a gain on an installment sale, you may be able to report part of your gain when you receive each payment. This method of reporting gain is called the installment method. You can't use the installment method to report a loss. You can choose to report all of your gain in the year of sale.

This publication discusses the general rules that apply to using the installment method. It also discusses more complex rules that apply only when certain conditions exist or certain types of property are sold.

If you sell your home or other nonbusiness property under an installment plan, you may need to read only the [General Rules](#) section, later. If you sell business or rental property or have a like-kind exchange or other complex situation, also see the appropriate discussion under [Other Rules](#), later.

Comments and suggestions. We welcome your comments about this publication and suggestions for future editions.

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Useful Items

You may want to see:

Publication

- ☐ **523** Selling Your Home

- ☐ **541** Partnerships
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions
- ☐ **Schedule B (Form 1040)** Interest and Ordinary Dividends
- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **Schedule D (Form 1041)** Capital Gains and Losses

- ☐ **Schedule D (Form 1065)** Capital Gains and Losses
- ☐ **Schedule D (Form 1120)** Capital Gains and Losses
- ☐ **Schedule D (Form 1120-S)** Capital Gains and Losses and Built-in Gains
- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **1040-NR** U.S. Nonresident Alien Income Tax Return
- ☐ **1040-SR** U.S. Income Tax Return for Seniors
- ☐ **1120** U.S. Corporation Income Tax Return
- ☐ **1120-F** U.S. Income Tax Return of a Foreign Corporation
- ☐ **4797** Sales of Business Property

- **6252** Installment Sale Income
- **8594** Asset Acquisition Statement Under Section 1060
- **8949** Sales and Other Dispositions of Capital Assets
- **8997** Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments

What's an Installment Sale?

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale.

The rules for installment sales don't apply if you elect not to use the installment method (see [*Electing Out of the Installment Method*](#), later) or the transaction is one for which the installment method may not apply.

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

Sale of inventory. The regular sale of inventory of personal property doesn't qualify as an installment sale even if you receive a payment after the year of sale. See [Sale of a Business](#), later.

Dealer sales. Sales of personal property by a person who regularly sells or otherwise disposes of the same type of personal property on the installment plan aren't installment sales. This rule also applies to real property held for sale to customers in the ordinary course of a trade or business. However, the rule doesn't apply to an installment sale of property used or produced in farming.

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. For more information, see section 453(l).

Stock or securities. You can't use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain on the sale in the year in which the trade date falls.

Installment obligation. The buyer's obligation to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you.

General Rules

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method.

See [*Electing Out of the Installment Method*](#), later, for information on recognizing the entire gain in the year of sale.

Fair market value (FMV). This is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of all the necessary facts.

Sale at a loss. If you sell property at a loss, you can't use the installment method. If the loss is on an installment sale of business or investment property, you can deduct it only in the tax year of sale.

Unstated interest and original issue discount. If your sale calls for payments in a later year and the sales contract provides for little or no interest, you may have to figure unstated interest or original issue discount (OID), even if you have a loss. See [*Unstated*](#)

Interest and Original Issue Discount (OID),
later.

Figuring Installment Sale Income

You can use the following discussions or Form 6252 to help you determine gross profit, contract price, gross profit percentage, and installment sale income.

Each payment on an installment sale usually consists of the following three parts.

- Interest income.
- Return of your adjusted basis in the property.
- Gain on the sale.

In each year you receive a payment, you must include in income both the interest part and the part that's your gain on the sale. You don't include in income the part that's the return of your basis in the property. Basis is the amount of your investment in the property for installment sale purposes. You

may have interest income in years you do not receive a payment.

Interest Income

You must report interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it's not called interest in your agreement with the buyer. Interest provided in the agreement is called stated interest. If the agreement doesn't provide for enough stated interest, there may be unstated interest or original issue discount (OID). You may have to include interest in income even in a year you receive no payment, depending on your regular method of accounting and whether the interest is unstated interest or OID. See [*Unstated Interest and Original Issue Discount \(OID\)*](#), later.

Adjusted Basis and Installment Sale Income (Gain on Sale)

After you've determined how much of each payment to treat as interest, you treat the rest of each payment as if it were made up of two parts.

- A tax-free return of your adjusted basis in the property.
- Your gain (referred to as installment sale income on Form 6252).

Figuring adjusted basis for installment sale purposes. You can use [Worksheet A](#) to figure your adjusted basis in the property for installment sale purposes. When you've completed the worksheet, you will also have determined the gross profit percentage necessary to figure your installment sale income (gain) for this year.

Worksheet A. **Figuring Adjusted Basis and Gross Profit Percentage**

Keep for Your Records 

1.	Enter the selling price for the property	_____
2.	Enter your adjusted basis for the property	_____
3.	Enter your selling expenses	_____
4.	Enter any depreciation recapture	_____
5.	Add lines 2, 3, and 4. This is your adjusted basis for installment sale purposes	_____
6.	Subtract line 5 from line 1. If zero or less, enter -0-. This is your gross profit	_____
	If the amount entered on line 6 is zero, stop here. You can't use the installment method.	_____
7.	Enter the contract price for the property	_____
8.	Divide line 6 by line 7. This is your gross profit percentage	_____

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Selling price. The selling price is the total cost of the property to the buyer and includes any of the following.

- Any money you are to receive.
- The FMV of any property you are to receive ([FMV](#) is discussed under *General Rules*, earlier).
- Any existing mortgage or other debt the buyer pays, assumes, or takes (a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property).
- Any of your selling expenses the buyer pays.

Don't include stated interest, unstated interest, any amount refigured or recharacterized as interest, or OID.

Adjusted basis for installment sale purposes. Your adjusted basis is the total of the following three items.

- Adjusted basis.
- Selling expenses.
- Depreciation recapture.

Adjusted basis. Basis is your investment in the property for installment sale purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of property you inherit, receive as a gift, build yourself, or receive in a tax-free exchange is figured differently.

While you own property, various events may change your original basis. Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as deductible casualty losses or depreciation previously allowed or allowable, decrease basis. The result is adjusted basis.

For more information on how to figure basis and adjusted basis, see Pub. 551. For more information regarding your basis in property

you inherited from someone who died in 2010 and whose executor filed Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, see Notice 2011-66, 2011-35 I.R.B. 184, available at [IRS.gov/irb/2011-35_IRB#NOT-2011-66](https://www.irs.gov/irb/2011-35_IRB#NOT-2011-66). For optional safe harbor guidance under section 1022, see Revenue Procedure 2011-41, 2011-35 I.R.B. 188, available at [IRS.gov/irb/2011-35_IRB#RP-2011-41](https://www.irs.gov/irb/2011-35_IRB#RP-2011-41).

Selling expenses. Selling expenses relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property.

Depreciation recapture. If the property you sold was depreciable property, you may need to recapture part of the gain on the sale as ordinary income. See [Depreciation Recapture Income](#), later.

Gross profit. Gross profit is the total gain you report on the installment method.

To figure your gross profit, subtract your adjusted basis for installment sale purposes from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See [Sale of your home](#), later.

Contract price. Contract price equals:

1. The selling price, minus
2. The mortgages, debts, and other liabilities assumed or taken by the buyer, plus
3. The amount by which the mortgages, debts, and other liabilities assumed or taken by the buyer exceed your adjusted basis for installment sale purposes.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as installment sale income. This percentage is called the gross profit percentage and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see the [*Example*](#) under *Selling Price Reduced*, later, for a situation where the gross profit percentage changes.

Example. You sell property at a contract price of \$6,000 and your gross profit is \$1,500. Your gross profit percentage is 25% ($\$1,500 \div \$6,000$). After subtracting interest, you report 25% of each payment, including the for the tax year you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.

Amount to report as installment sale income. Multiply the payments you receive each year (less interest) by the gross profit percentage. The result is your installment sale income for the tax year. In certain circumstances, you may be treated as having received a payment, even though you received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment. For a detailed discussion, see [*Payments Received or Considered Received*](#), later.

Selling Price Reduced

If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. Refigure your gross profit using [*Worksheet B*](#). You will spread any remaining gain over future installments.

Example. In 2021, you sold land with a basis of \$40,000 for \$100,000. Your gross profit was \$60,000. In 2021, you received a \$20,000 down payment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 8% interest, beginning in 2022. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 2021 and 2022.

In 2023, you and the buyer agreed to reduce the purchase price to \$85,000 and payments during 2023, 2024, and 2025 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured on [Example—Worksheet B](#).

You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 2023, 2024, and 2025.

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Worksheet B. **New Gross Profit Percentage—Selling Price
Reduced**

Keep for Your Records 

1.	Enter the reduced selling price for the property	_____
2.	Enter your adjusted basis for the property	_____
3.	Enter your selling expenses	_____
4.	Enter any depreciation recapture	_____
5.	Add lines 2, 3, and 4	_____
6.	Subtract line 5 from line 1. This is your adjusted gross profit	_____
7.	Enter any installment sale income reported in prior year(s)	_____
8.	Subtract line 7 from line 6	_____
9.	Future installments	_____
10.	Divide line 8 by line 9. This is your new gross profit percentage*	_____

Example— New Gross Profit Worksheet B. Percentage—Selling Price Reduced

1.	Enter the reduced selling price for the property	85,000
2.	Enter your adjusted basis for the property	40,000
3.	Enter your selling expenses	-0-
4.	Enter any depreciation recapture	-0-
5.	Add lines 2, 3, and 4	40,000
6.	Subtract line 5 from line 1. This is your adjusted gross profit	45,000
7.	Enter any installment sale income reported in prior year(s)	24,000
8.	Subtract line 7 from line 6	21,000
9.	Future installments	45,000
10.	Divide line 8 by line 9. This is your new gross profit percentage*	46.67%

* Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.

Reporting Installment Sale Income

Generally, you will use Form 6252 to report installment sale income from casual sales of real or personal property during the tax year. You will also have to report the installment sale income on Schedule D (Form 1040), Form 4797, or both. If the property was your main home, you may be able to exclude part or all of the gain.

For more information on how to report your income from an installment sale, see [*Reporting an Installment Sale*](#), later.

Other Rules

The rules discussed in this part of the publication apply only in certain circumstances or to certain types of property. The following topics are discussed.

- Electing out of the installment method.

- Payments received or considered received.
- Escrow account.
- Depreciation recapture income.
- Sale to a related person.
- Like-kind exchange.
- Contingent payment sale.
- Single sale of several assets.
- Sale of a business.
- Unstated interest and OID.
- Disposition of an installment obligation.
- Repossession.
- Interest on deferred tax.

Electing Out of the Installment Method

If you elect not to use the installment method, you generally report the entire gain

in the year of sale, even though you don't receive all the sale proceeds in that year.

Use Regulations section 1.1001-1(g) to figure the amount of gain to report from a buyer's installment obligation that is a debt instrument. Generally, the amount realized is the issue price of the buyer's debt instrument, or (if the buyer's debt instrument has an issue price determined as its stated redemption price at maturity) the instrument's stated principal amount reduced by any unstated interest (as determined under section 483).

Example. You sold a parcel of land for \$50,000. You received a \$10,000 down payment and will receive the balance over the next 10 years at \$4,000 a year, plus 8% interest. The buyer gave you a note for \$40,000, and the note has adequate stated interest. The note has an issue price of \$40,000. You paid a commission of 6%, or \$3,000, to a broker for negotiating the sale. The land cost \$25,000, and you owned it for

more than 1 year. You decide to elect out of the installment method and report the entire gain in the year of sale.

Gain realized:

Selling price		\$50,000
Minus: Property's adjusted basis . . .	\$25,000	
Commission	3,000	28,000
Gain realized		<u><u>\$22,000</u></u>

Gain recognized in year of sale:

Cash		\$10,000
Issue price of note		40,000
Total realized in year of sale		\$50,000
Minus: Property's adjusted basis . . .	\$25,000	
Commission	3,000	28,000
Gain recognized		<u><u>\$22,000</u></u>

The recognized gain of \$22,000 is long-term capital gain. You include the entire gain in income in the year of sale, so you don't include in income any principal payments you receive in later tax years. The interest on the note is ordinary income and is reported as interest income each year.

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. A revocation is retroactive. You won't be allowed to revoke the election if either of the following applies.

- One of the purposes is to avoid federal income tax.

- The tax year in which any payment was received has closed.

Payments Received or Considered Received

Unless you elected out of the installment method, you must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale.

In certain situations, you're considered to have received a payment, even though the buyer doesn't pay you directly. These situations occur when the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission. However, as discussed later, the buyer's assumption of your debt is treated as a recovery of your basis rather than as a payment in many cases.

Buyer Pays Seller's Expenses

If the buyer pays any of your expenses related to the sale of your property, it's considered a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer Assumes Mortgage

If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to the mortgage, the following rules apply.

Mortgage not more than basis. If the buyer assumes a mortgage that isn't more than your installment sale basis in the property, it isn't considered a payment to you. It's considered a recovery of your basis. The contract price is the selling price minus the mortgage.

Example. You sell property with an adjusted basis of \$19,000. You have selling expenses

of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you \$10,000 (a cash down payment of \$2,000 and \$2,000 (plus 12% interest) in each of the next 4 years).

The selling price is \$25,000 (\$15,000 + \$10,000). Your gross profit is \$5,000 (\$25,000 – \$20,000 installment sale basis). The contract price is \$10,000 (\$25,000 – \$15,000 mortgage). Your gross profit percentage is 50% (\$5,000 ÷ \$10,000). You report half of each \$2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that's more than your installment sale basis in the property, you recover your entire basis. The part of the mortgage greater than your basis is treated as a payment received in the year of sale.

To figure the contract price, subtract the mortgage from the selling price. This is the total amount (other than interest) you'll receive directly from the buyer. Add to this amount the payment you're considered to have received (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale.



If the mortgage the buyer assumes is equal to or more than your installment sale basis, the gross profit percentage will always be 100%.

Example. The selling price for your property is \$9,000. The buyer will pay you \$1,000 annually (plus 8% interest) over the next 3 years and will assume an existing mortgage of \$6,000. Your adjusted basis in the property is \$4,400. You have selling expenses of \$600, for a total installment sale basis of \$5,000. The part of the mortgage that's more than your installment sale basis is \$1,000

(\$6,000 – \$5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is \$4,000.

Selling price		\$9,000
Minus: Mortgage		6,000
Amount actually received		<u>\$3,000</u>
Add difference:		
Mortgage	\$6,000	
Minus: Installment sale basis	<u>5,000</u>	<u>1,000</u>
Contract price.		<u><u>\$4,000</u></u>

Your gross profit on the sale is also \$4,000.

Selling price	\$9,000
Minus: Installment sale basis	5,000
Gross profit	<u><u>\$4,000</u></u>

Your gross profit percentage is 100%. Report 100% of each payment (less interest) as gain from the sale. Treat the \$1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

Mortgage Canceled

If the buyer of your property is the person who holds the mortgage on it, your debt is canceled, not assumed. You're considered to receive a payment equal to the outstanding canceled debt.

Example. Taylor Santiago loaned you \$45,000 in 2019 in exchange for a note and a mortgage in a tract of land you owned. On April 1, 2023, Taylor bought the land for \$70,000. At that time, \$30,000 of their loan to you was outstanding. Taylor agreed to forgive this \$30,000 debt and to pay you \$20,000 (plus interest) on August 1, 2023, and \$20,000 on August 1, 2024. Taylor didn't assume an existing mortgage and canceled the \$30,000 debt you owed them. You're considered to have received a \$30,000 payment at the time of the sale.

Buyer Assumes Other Debts

If the buyer assumes any other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it's more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that's more than your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under *Buyer Assumes Mortgage*. However, they only apply to the following types of debt the buyer assumes.

- Those acquired from ownership of the property you're selling, such as a

mortgage, lien, overdue interest, or back taxes.

- Those acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan or your legal fees relating to the sale, it's treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of sale.

Property Used as a Payment

If you receive property other than money from the buyer, it's generally considered a payment in the year received. However, see [*Like-Kind Exchange*](#), later.

Generally, the amount treated as payment is the property's FMV on the date you receive it.

Exception. If the buyer gives you a note that is payable on demand or readily tradable, the note is treated as a payment in the year received. If treating the note as a current payment causes the sale not to be an installment sale, determine the amount realized under Regulations section 1.1001-1(g). If the note that is payable on demand or readily tradable is received as a payment in an installment sale, the amount you should consider as payment in the year received generally is:

- If you use the cash method of accounting, the FMV of the note on the date you receive it;
- If you use the accrual method of accounting and the note is payable on demand, the face amount of the obligation on the date you receive it; or
- If you use an accrual method of accounting and the note is readily tradable, the stated redemption price at

maturity less any OID or, if there's no OID, the stated redemption price at maturity appropriately discounted to reflect total unstated interest. See [Unstated Interest and Original Issue Discount \(OID\)](#), later.

Debt not payable on demand or readily tradable. Any evidence of debt you receive from the buyer that is not payable on demand or readily tradable generally isn't considered a payment. This is true even if the debt is guaranteed by a third party, including a government agency.

Third-party note. If the property the buyer gives you is a third-party note (or other obligation of a third party), you're considered to have received a payment equal to the note's FMV. Because the FMV of the note is itself a payment on your installment sale, any payments you later receive from the third party aren't considered payments on the sale. The excess of the note's face value over its

FMV is market discount that is subject to the market discount rules under sections 1276 and 1278. Exclude this market discount in determining the selling price of the property. However, see [Exception](#) under *Property Used as a Payment*, earlier.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$50,000, 8% interest third-party note. The FMV of the third-party note at the time of the sale was \$30,000. This amount, not \$50,000, is a payment to you in the year of sale. The excess of the \$50,000 face value of the note over the \$30,000 FMV, or \$20,000, is market discount that is subject to the market discount rules in sections 1276 and 1278.

Bond. A bond or other evidence of debt you receive from the buyer that's payable on demand or readily tradable in an established securities market is treated as a payment in the year you receive it. For more information

on the amount you should treat as a payment, see [Exception](#) under *Property Used as a Payment*, earlier.

If you receive a government or corporate bond for a sale before October 22, 2004, and the bond has interest coupons attached or can be readily traded in an established securities market, you're considered to have received payment equal to the bond's FMV. However, see [Exception](#) under *Property Used as a Payment*, earlier.

Buyer's note. The buyer's note (unless payable on demand or readily tradable) isn't considered payment on the sale. However, its full face value is included when figuring the selling price and the contract price. The selling price should be reduced by any OID or unstated interest. Payments you receive on the note are used to figure your gain in the year received.

Installment Obligation Used as Security (Pledge Rule)

If you use an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is known as the pledge rule, and it applies if the selling price of the property is over \$150,000. It doesn't apply to the following dispositions.

- Sales of property used or produced in farming.
- Sales of personal-use property.
- Qualifying sales of timeshares and residential lots.

The net debt proceeds are the gross debt minus the direct expenses of getting the debt. The amount treated as a payment is considered received on the later of the following dates.

- The date the debt becomes secured.

- The date you receive the debt proceeds.

A debt is secured by an installment obligation to the extent that payment of principal or interest on the debt is directly secured (under the terms of the loan or any underlying arrangement) by any interest in the installment obligation.

For sales after December 16, 1999, payment on a debt is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows you to satisfy all or part of the debt with the installment obligation.

Limit. The net debt proceeds treated as a payment on the pledged installment obligation can't be more than the excess of item (1) over item (2) below.

1. The total contract price on the installment sale.
2. Any payments received on the installment obligation before the date

the net debt proceeds are treated as a payment.

Installment payments. The pledge rule accelerates the reporting of the installment obligation payments. Don't report payments received on the obligation after it's been pledged until the payments received exceed the amount reported under the pledge rule.

Exception. The pledge rule doesn't apply to pledges made after December 17, 1987, to refinance a debt under the following circumstances.

- The debt was outstanding on December 17, 1987.
- The debt was secured by that installment sale obligation on that date and at all times thereafter until the refinancing occurred.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt so long as a person other

than the creditor or a person related to the creditor provides the refinancing.

This exception applies only to refinancing that doesn't exceed the principal of the original debt immediately before the refinancing. Any excess is treated as a payment on the installment obligation.

Escrow Account

In some cases, the sales agreement or a later agreement may call for the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. These sales can't be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

Example. You sell property for \$100,000. The sales agreement calls for a down payment of \$10,000 and payment of \$15,000 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. You can't report the sale on the installment method because the full purchase price is considered received in the year of sale. You report the entire gain in the year of sale.

Escrow established in a later year. If you make an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation.

Substantial restriction. If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies. For

an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer.

Depreciation Recapture Income

If you sell property for which you claimed or could have claimed a depreciation deduction, you must report any depreciation recapture income in the year of sale, whether or not an installment payment was received that year. Figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. The recapture income is also included in Part I of Form 6252. However, the gain equal to the recapture income is reported in full in the year of the sale. Only the gain greater than the recapture income is

reported on the installment method. For more information on depreciation recapture, see chapter 3 of Pub. 544.

The recapture income reported in the year of sale is included in your installment sale basis in determining your gross profit on the installment sale. Determining gross profit is discussed under [*General Rules*](#), earlier.

Sale to a Related Person

If you sell depreciable property to a related person and the sale is an installment sale, you may not be able to report the sale using the installment method. If you sell property to a related person and the related person disposes of the property before you receive all payments with respect to the sale, you may have to treat the amount realized by the related person as received by you when the related person disposes of the property. These rules are explained under *Sale of*

Depreciable Property and under *Sale and Later Disposition*, later.

Sale of Depreciable Property

If you sell depreciable property to certain related persons, you generally can't report the sale using the installment method.

Instead, all payments to be received are considered received in the year of sale.

However, see *Exception* below. Depreciable property for this rule is any property the purchaser can depreciate.

Payments to be received include the total of all noncontingent payments and the FMV of any payments contingent as to amount.

In the case of contingent payments for which the FMV can't be reasonably determined, your basis in the property is recovered proportionately. The purchaser can't increase the basis of the property acquired in the sale before the seller includes a like amount in income.

Exception. You can use the installment method to report a sale of depreciable property to a related person if no significant tax deferral benefit will be derived from the sale.

You must show to the satisfaction of the IRS that avoidance of federal income tax wasn't one of the principal purposes of the sale.

Related person. Related persons include the following.

- 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).

Sale and Later Disposition

Generally, a special rule applies if you sell or exchange property to 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. This rule doesn't apply if the property involved is marketable securities.

Under this rule, you treat part or all of the amount the related person realizes (or the FMV if the disposed property isn't sold or exchanged) from the second disposition as if you received it at the time of the second disposition.

See [Exception](#), later.

Related person. Related persons include the following.

- 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 an owner of the trust.

- 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.

Example 1. In 2022, you sold farm land to your child Adrian for \$500,000, which was to be paid in five equal payments over 5 years,

plus adequate stated interest on the balance due. Your installment sale basis for the farmland was \$250,000 and the property wasn't subject to any outstanding liens or mortgages. Your gross profit percentage is 50% (gross profit of \$250,000 ÷ contract price of \$500,000). You received \$100,000 in 2022 and included \$50,000 in income for that year ($\$100,000 \times 0.50$). Adrian made no improvements to the property and sold it to Alfalfa Inc. in 2023 for \$600,000 after making the payment for that year. The amount realized from the second disposition is \$600,000. You figured your installment sale income for 2023 as follows.

Lesser of: 1) Amount realized on second disposition, or 2) Contract price on first disposition	\$500,000
Subtract: Sum of payments from Adrian in 2022 and 2023	<u>– 200,000</u>

Amount treated as received because of second disposition	\$300,000
Add: Payment from Adrian in 2023	<u>+ 100,000</u>
Total payments received and treated as received for 2023	\$400,000
Multiply by gross profit %	<u>× 0.50</u>
Installment sale income for 2023	<u>\$200,000</u>

You won't include in your installment sale income any principal payments you receive on the installment obligation for 2024, 2025, and 2026 because you already reported the total payments of \$500,000 from the first disposition (\$100,000 in 2022 and \$400,000 in 2023).

Example 2. Assume the facts are the same as *Example 1*, except that Adrian sells the property for only \$400,000. The gain for 2023 is figured as follows.

Lesser of: 1) Amount realized on
second disposition, or 2) Contract
price on first disposition \$400,000

Subtract: Sum of payments from
Adrian in 2022 and 2023 – 200,000

Amount treated as received
because of second disposition \$200,000

Add: Payment from Adrian in 2023 + 100,000

Total payments received and
treated as received for 2023 \$300,000

Multiply by gross profit % × 0.50

Installment sale income for 2023 ... \$150,000

You receive a \$100,000 payment in 2024 and
another in 2025. They aren't taxed because
you treated the \$200,000 from the
disposition in 2023 as a payment received

and paid tax on the installment sale income. In 2026, you receive the final \$100,000 payment. You figure the installment sale income you must recognize in 2026 as follows.

Total payments from the first disposition received by the end of 2026	\$500,000
Minus the sum of:	
Payment from 2022	\$100,000
Payment from 2023	100,000
Amount treated as received in 2023	<u>200,000</u>
Total on which gain was previously recognized	<u>– 400,000</u>
Payment on which gain is recognized for 2026	\$100,000
Multiply by gross profit %	<u>× 0.50</u>
Installment sale income for 2026	<u><u>\$50,000</u></u>

Exception. This rule doesn't apply to a second disposition, and any later transfer, if you can show to the satisfaction of the IRS that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, an involuntary second disposition will qualify under the nontax avoidance exception, such

as when a creditor of the related person forecloses on the property or the related person declares bankruptcy.

The nontax avoidance exception also applies to a second disposition that's also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception doesn't apply if the resale terms permit significant deferral of recognition of gain from the first sale.

In addition, any sale or exchange of stock to the issuing corporation isn't treated as a first disposition. An involuntary conversion isn't treated as a second disposition if the first disposition occurred before the threat of conversion. A transfer after the death of the person making the first disposition or the related person's death, whichever is earlier, isn't treated as a second disposition.

Like-Kind Exchange

If you trade business or investment real property solely for other business or investment real property of a like kind, you can postpone reporting the gain from the trade. These trades are known as like-kind exchanges. The property you receive in a like-kind exchange is treated as if it were a continuation of the property you gave up. A trade is not a like-kind exchange if the property you trade or the property you receive is property you hold primarily for sale to customers.

You don't have to report any part of your gain if you receive only like-kind property.

However, if you also receive money or other property (boot) in the exchange, you must report your gain to the extent of the money and the FMV of the other property received.

For more information on like-kind exchanges, see *Like-Kind Exchanges* in chapter 1 of Pub. 544.

Installment payments. If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply to determine the installment sale income each year.

- The contract price is reduced by the FMV of the like-kind property received in the trade.
- The gross profit is reduced by any gain on the trade that can be postponed.
- Like-kind property received in the trade isn't considered payment on the installment obligation.

Example. In 2023, you trade real property with an installment sale basis of \$400,000 for like-kind property having an FMV of \$200,000. You also receive an installment note for \$800,000 in the trade. Under the

terms of the note, you are to receive \$100,000 (plus interest) in 2024 and the balance of \$700,000 (plus interest) in 2025.

Your selling price is \$1,000,000 (\$800,000 installment note + \$200,000 FMV of like-kind property received). Your gross profit is \$600,000 (\$1,000,000 – \$400,000 installment sale basis). The contract price is \$800,000 (\$1,000,000 – \$200,000). The gross profit percentage is 75% (\$600,000 ÷ \$800,000). You report no gain in 2023 because the like-kind property you receive isn't treated as a payment for figuring gain. You report \$75,000 gain for 2024 (75% of \$100,000 payment received) and \$525,000 gain for 2025 (75% of \$700,000 payment received).

Deferred exchanges. A deferred exchange is one in which you transfer property you use in business or hold for investment and receive like-kind property later that you'll use in business or hold for investment. Under this

type of exchange, the person receiving your property may be required to place funds in an escrow account or trust. If certain rules are met, these funds won't be considered a payment until you have the right to receive the funds or, if earlier, the end of the exchange period. See Regulations section 1.1031(k)-1(j)(2) for these rules.

Exchanges started in and completed after 2017. Under the Tax Cuts and Jobs Act, a trade is not a like-kind exchange unless the taxpayer trades and receives real property, other than real property held primarily for sale. Before enactment of the new tax law, certain exchanges of personal or intangible property qualified as like-kind exchanges.

Contingent Payment Sale

A contingent payment sale is one in which the total selling price can't be determined by the end of the tax year of sale. This happens, for

example, if you sell your business and the selling price includes a percentage of its profits in future years.

If the selling price can't be determined by the end of the tax year, you must use different rules to figure the contract price and the gross profit percentage than those you use for an installment sale with a fixed selling price.

For rules on using the installment method for a contingent payment sale, see Regulations section 15a.453-1(c).

Single Sale of Several Assets

If you sell different types of assets in a single sale, you must identify each asset to determine whether you can use the installment method to report the sale of that asset. You also have to allocate part of the selling price to each asset. If you sell assets that constitute a trade or business, see [*Sale of a Business*](#), later.

Unless an allocation of the selling price has been agreed to by both parties in an arm's-length transaction, you must allocate the selling price to an asset based on its FMV. If the buyer assumes a debt, or takes the property subject to a debt, you must reduce the FMV of the property by the debt. This becomes the net FMV.

A sale of separate and unrelated assets of the same type under a single contract is reported as one transaction for the installment method. However, if an asset is sold at a loss, its disposition can't be reported on the installment method. It must be reported separately. The remaining assets sold at a gain are reported together.

Example. You sold three separate and unrelated parcels of real property (A, B, and C) under a single contract calling for a total selling price of \$130,000. The total selling price consisted of a cash payment of \$20,000, the buyer's assumption of a \$30,000

mortgage on parcel B, and an installment obligation of \$80,000 payable in eight annual installments, plus interest at 8% a year.

Your installment sale basis for each parcel was \$15,000. Your net gain was \$85,000 (\$130,000 – \$45,000). You report the gain on the installment method.

The sales contract didn't allocate the selling price or the cash payment received in the year of sale among the individual parcels. The FMV of parcels A, B, and C were \$60,000, \$60,000, and \$10,000, respectively.

The installment sale basis for parcel C was more than its FMV, so it was sold at a loss and must be treated separately. You must allocate the total selling price and the amounts received in the year of sale between parcel C and the remaining parcels.

Of the total \$130,000 selling price, you must allocate \$120,000 to parcels A and B together and \$10,000 to parcel C. You should allocate

the cash payment of \$20,000 received in the year of sale and the note receivable on the basis of their proportionate net FMVs. The allocation is figured as follows.

	Parcels A and B	Parcel C
FMV	\$120,000	\$10,000
Minus: Mortgage assumed	30,000	-0-
Net FMV	<u>\$90,000</u>	<u>\$10,000</u>
Proportionate net FMV:		
Percentage of total	90%	10%
Payments in year of sale:		
\$20,000 × 90% (0.90)	\$18,000	
\$20,000 × 10% (0.10)		\$2,000
Excess of parcel B mortgage over installment sale basis	<u>15,000</u>	<u>-0-</u>
Allocation of payments received (or considered received) in year of sale	<u>\$33,000</u>	<u>\$2,000</u>

You can't report the sale of parcel C on the installment method because the sale results in a loss. You report this loss of \$5,000 (\$10,000 selling price – \$15,000 installment

sale basis) in the year of sale. However, if parcel C was held for personal use, the loss isn't deductible.

You allocate the installment obligation of \$80,000 to the properties sold based on their proportionate net FMVs (90% to parcels A and B, 10% to parcel C).

Sale of a Business

The installment sale of an entire business for one overall price under a single contract isn't the sale of a single asset.

Allocation of Selling Price

To determine whether any of the gain on the sale of the business can be reported on the installment method, you must allocate the total selling price and the payments received in the year of sale between each of the following classes of assets.

1. Assets sold at a loss.

2. Real and personal property eligible for the installment method.
3. Real and personal property ineligible for the installment method, including:
 - a. Inventory,
 - b. Dealer property, and
 - c. Stocks and securities.

Inventory. The sale of inventories of personal property can't be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if you receive payment in later years.

If inventory items are included in an installment sale, you may have an agreement stating which payments are for inventory and which are for the other assets being sold. If you don't, each payment must be allocated between the inventory and the other assets sold.

Report the amount you receive (or will receive) on the sale of inventory items as ordinary business income. Use your basis in the inventory to figure the cost of goods sold. Deduct the part of the selling expenses allocated to inventory as an ordinary business expense.

Residual method. Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the residual method to allocate the sale price to each business asset sold. This method determines gain or loss from the transfer of each asset and the buyer's basis in the assets.

The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest

in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b).

A group of assets constitutes a trade or business if goodwill or going concern value could, under any circumstances, attach to the assets or if the use of the assets would constitute an active trade or business under section 355.

The residual method provides for the consideration to be reduced first by cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposit). The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

For asset acquisitions occurring after March 15, 2001, make the allocation among the following assets in proportion to (but not more than) their FMVs on the purchase date in the following order.

1. Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
2. Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see Regulations section 1.338-6(b)(2)(iii) for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
3. Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.

4. All other assets except section 197 intangibles.
5. Section 197 intangibles except goodwill and going concern value.
6. Goodwill and going concern value (whether or not they qualify as section 197 intangibles).

If an asset described in (1) through (6) is includible in more than one category, include it in the lower number category. For example, if an asset is described in both (4) and (6), include it in (4).

Agreement. The buyer and seller may enter into a written agreement as to the allocation of any consideration or the FMV of any of the assets. This agreement is binding on both parties unless the IRS determines the amounts aren't appropriate.

Reporting requirement. Both the buyer and seller involved in the sale of business assets

must report to the IRS the allocation of the sales price among section 197 intangibles and the other business assets. Use Form 8594 to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.

Sale of Partnership Interest

A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. The part of any gain or loss from unrealized receivables or inventory items will be treated as ordinary income. (The term “unrealized receivables” includes income arising from compensation for services and depreciation recapture income, discussed earlier.)

The gain allocated to the unrealized receivables and the inventory can't be

reported under the installment method. The gain allocated to the other assets can be reported under the installment method.

For more information on the treatment of unrealized receivables and inventory, see Pub. 541.

Example—Sale of a Business

On June 4, 2023, you sold the machine shop you'd operated since 2014. You received a \$100,000 down payment and the buyer's note for \$120,000. The note payments are \$15,000 each, plus 10% interest, due every July 1 and January 1, beginning in 2024. The total selling price is \$220,000. Your selling expenses are \$11,000.

The selling expenses are divided among all the assets sold, including inventory. Your selling expense for each asset is 5% of the asset's selling price (\$11,000 selling expense ÷ \$220,000 total selling price).

The FMV, adjusted basis, and depreciation claimed on each asset sold are as follows.

<u>Asset</u>	<u>FMV</u>	<u>Depre- ciation Claimed</u>	<u>Adj. Basis</u>
Inventory	\$10,000	-0-	\$8,000
Land	42,000	-0-	15,000
Building	48,000	\$9,000	36,000
Machine A	71,000	27,200	63,800
Machine B	24,000	12,960	22,040
Truck	6,500	18,624	5,376
Total	<u>\$201,500</u>	<u>\$67,784</u>	<u>\$150,216</u>

Under the residual method, you allocate the selling price to each of the assets based on their FMV (\$201,500). The remaining \$18,500 (\$220,000 – \$201,500) is allocated to your section 197 intangible goodwill.

The assets included in the sale, their selling prices based on their FMVs, the selling expense allocated to each asset, the adjusted basis, and the gain for each asset are shown in the following chart.

	<u>Sale Price</u>	<u>Sale Exp.</u>	<u>Adj. Basis</u>	<u>Gain</u>
Inventory	\$10,000	\$500	\$8,000	\$1,500
Land	42,000	2,100	15,000	24,900
Building	48,000	2,400	36,000	9,600
Mch. A	71,000	3,550	63,800	3,650
Mch. B	24,000	1,200	22,040	760
Truck	6,500	325	5,376	799
Goodwill	18,500	925	-0-	17,575
Total	<u>\$220,000</u>	<u>\$11,000</u>	<u>\$150,216</u>	<u>\$58,784</u>

The building was acquired in 2014, the year the business began, and it's section 1250 property. There's no depreciation recapture income because the building was depreciated using the straight line method.

All gain on the truck, machine A, and machine B is depreciation recapture income since it's the lesser of the depreciation claimed or the gain on the sale. Figure depreciation recapture in Part III of Form 4797.

The total depreciation recapture income reported in Part II of Form 4797 is \$5,209. This consists of \$3,650 on machine A, \$799 on the truck, and \$760 on machine B (the gain on each item because it was less than the depreciation claimed). These gains are reported in full in the year of sale and aren't included in the installment sale computation.

Of the \$220,000 total selling price, the \$10,000 for inventory assets can't be reported using the installment method. The selling prices of the truck and machines are also removed from the total selling price because gain on these items is reported in full in the year of sale.

The selling price equals the contract price for the installment sale (\$108,500). The assets included in the installment sale, their selling price, and their installment sale bases are shown in the following chart.

	<u>Selling Price</u>	<u>Install- ment Sale Basis</u>	<u>Gross Profit</u>
Land	\$42,000	\$17,100	\$24,900
Building	48,000	38,400	9,600
Goodwill	18,500	925	17,575
Total	<u>\$108,500</u>	<u>\$56,425</u>	<u>\$52,075</u>

The gross profit percentage (gross profit ÷ contract price) for the installment sale is 48% (\$52,075 ÷ \$108,500). The gross profit percentage for each asset is figured as follows.

	<u>Percentage</u>
Land— \$24,900 ÷ \$108,500	22.95
Building— \$9,600 ÷ \$108,500	8.85
Goodwill— \$17,575 ÷ \$108,500	16.20
Total	<u>48.00</u>

The sale includes assets sold on the installment method and assets for which the gain is reported in full in the year of sale, so payments must be allocated between the installment part of the sale and the part

reported in the year of sale. The selling price for the installment sale is \$108,500. This is 49.3% of the total selling price of \$220,000 ($\$108,500 \div \$220,000$). The selling price of assets not reported on the installment method is \$111,500. This is 50.7% ($\$111,500 \div \$220,000$) of the total selling price.

Multiply principal payments by 49.3% (0.493) to determine the part of the payment for the installment sale. The balance, 50.7%, is for the part reported in the year of the sale.

The gain on the sale of the inventory, machines, and truck is reported in full in the year of sale. When you receive principal payments in later years, no part of the payment for the sale of these assets is included in gross income. Only the part for the installment sale (49.3%) is used in the installment sale computation.

The only payment received in 2023 is the down payment of \$100,000. The part of the payment for the installment sale is \$49,300

(\$100,000 × 49.3% (0.493)). This amount is used in the installment sale computation.

Installment income for 2023. Your installment income for each asset is the gross profit percentage for that asset times \$49,300, the installment income received in 2023.

	<u>Income</u>
Land—22.95% of \$49,300	\$11,314
Building—8.85% of \$49,300	4,363
Goodwill—16.2% of \$49,300	7,987
	<hr/>
Total installment income for 2023 . .	\$23,664
	<hr/>

Installment income after 2023. You figure installment income for years after 2023 by applying the same gross profit percentages to 49.3% of the total payments you receive on the buyer's note during the year.

Unstated Interest and Original Issue Discount (OID)

An installment sale contract may provide that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the principal payment. Interest provided in the contract is called stated interest.

If an installment sale contract doesn't provide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest. If section 483 applies to the contract, this interest is called unstated interest. If section 1274 applies to the contract, this interest is called OID.

An installment sale contract doesn't provide for adequate stated interest if the stated interest rate is lower than the test rate. See *Test rate of interest*, later.

Treatment of unstated interest and OID.

Generally, if a buyer gives a debt in

consideration for personal-use property, the unstated interest rules under section 483 and the OID rules under section 1274 don't apply to the buyer. As a result, the buyer can't deduct the unstated interest or OID. The seller must report the unstated interest or OID as income.

Personal-use property is any property in which substantially all of its use by the buyer isn't in connection with a trade or business or an investment activity.

If the debt is subject to the section 483 rules and is also subject to the below-market loan rules, such as a gift loan, compensation-related loan, or corporation-shareholder loan, then both parties are subject to the below-market loan rules rather than the unstated interest rules.

Rules for the seller. If either section 1274 or section 483 applies to the installment sale contract, you must treat part of the installment sale price as interest, even if

stated interest isn't called for in the sales agreement. If either section applies, you must reduce the stated selling price of the property and increase your interest income by this unstated interest or OID.

Include any unstated interest in income based on your regular method of accounting.

Include any OID in income over the term of the contract.

The OID includible in income each year is based on the constant yield method described in section 1272. (In some cases, the OID on an installment sale contract may also include all or part of the stated interest, especially if the stated interest isn't paid at least annually.)

If you don't use the installment method to report the sale, report the entire gain under your method of accounting in the year of sale. Reduce the selling price by any stated principal treated as interest to determine the gain.

Report unstated interest or OID on your tax return, in addition to stated interest (without double-counting any stated interest treated as OID).

Rules for the buyer. Any part of the stated selling price of an installment sale contract treated by the buyer as interest reduces the buyer's basis in the property and increases the buyer's interest expense. These rules don't apply to personal-use property (for example, property not used in a trade or business).

Adequate stated interest. An installment sale contract generally provides for adequate stated interest if the contract's stated principal amount is less than or equal to the sum of the present values of all principal and interest payments called for under the contract. The present value of a payment is determined based on the test rate of interest, defined next. (If section 483 applies to the contract, payments due within 6 months after

the sale are taken into account at face value.) In general, an installment sale contract provides for adequate stated interest if the stated interest rate (based on an appropriate compounding period) is at least equal to the test rate of interest.

Test rate of interest. The test rate of interest for a contract is the 3-month rate. The 3-month rate is the lower of the following applicable federal rates (AFRs).

- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there's a binding written contract that substantially provides the terms under which the sale or exchange is ultimately completed.
- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

Applicable federal rate (AFR). The AFR depends on the month the binding contract for the sale or exchange of property is made or the month of the sale or exchange and the term of the instrument. For an installment obligation, the term of the instrument is its weighted average maturity, as defined in Regulations section 1.1273-1(e)(3). The AFR for each term is shown below.

- For a term of 3 years or less, the AFR is the federal short-term rate.
- For a term of over 3 years, but not over 9 years, the AFR is the federal mid-term rate.
- For a term of over 9 years, the AFR is the federal long-term rate.



The AFRs are published monthly in the Internal Revenue Bulletin (IRB). You can get this information at

[IRS.gov/ApplicableFederalRates](https://www.irs.gov/ApplicableFederalRates).

Seller-financed sales. For sales or exchanges of property (other than new section 38 property, which includes most tangible personal property subject to depreciation) involving seller financing of \$6,734,800 or less, the test rate of interest can't be more than 9%, compounded semiannually.

For information on new section 38 property, see section 48(b) as in effect before the enactment of Public Law 101-508.

Certain land transfers between related persons. In the case of certain land transfers between related persons (described later), the test rate is no more than 6%, compounded semiannually.