

Use the Installment Method to Defer Taxes on Property Sales

When at least one payment is received after the tax year in which the sale occurs, you can use the installment method to defer a portion of the income tax due on a gain from the sale of property such as an apartment or office building.

Under the installment method, the seller recognizes a portion of each payment as gain when received. Typically, each payment the seller receives consists of three parts: (1) a return of basis (investment) in the property sold, (2) gain (profit) on the sale, and (3) interest on the installment note. Only the gain and interest portions of each payment are taxable to the seller. Reporting gain from the disposition of property under the installment method allows the seller to report the taxable gain and spread the tax over several years rather than all in the year of sale. Thus, the seller's payment of tax corresponds with the actual cash flow generated from the sale.

Example: Deferring taxable gain using the installment sale method.

Mark is a real estate investor, but is not a dealer in real property. In February 2004, he sold an apartment complex for \$5 million, receiving \$500,000 cash and a \$4.5 million note. His basis (investment) in the property was \$3 million. The note calls for annual installment payments beginning in February 2005. He will receive interest on the note commensurate with the market and the buyer is not a related party. Mark will use the installment sale method to report his taxable gain. Mark's total gain on the sale of the apartment complex is \$2 million (the \$5 million sale proceeds less his \$3 million basis), which is 40% (gross profit ratio) of the selling price. For 2004, he will report a taxable gain of \$200,000 computed by multiplying the \$500,000 received in cash during 2004 by the 40% gross profit ratio. The remaining \$300,000 is a nontaxable return of Mark's original investment. As installment payments are received beginning in 2005, he will report any interest received and 40% of the principal payment as taxable income. The remaining 60% of the principal payment is a return of his investment.

There are several restrictions and limitations on the use of the installment method. But, as the example indicates, significant tax deferral can be achieved using this method to report qualified property gains. Please call us to discuss this and other appropriate tax saving and deferral techniques for you and your business.

