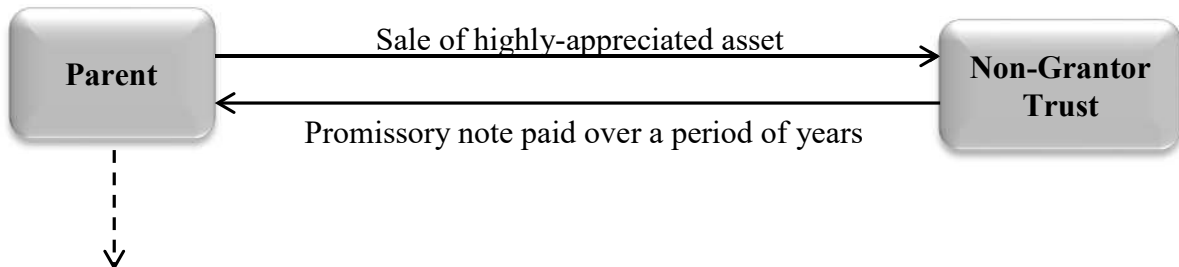


#9: Two-Year Installment Sale Strategy

Prior to 1980, taxpayers used a double sale strategy to create a timing mismatch between realization of appreciation and realization of taxable gain. By using this strategy to transfer property to their children, the children could receive the full value of appreciated property in cash before any taxable gain was recognized.

- Parent (P) owns Blackacre, undeveloped land with a basis of \$100,000 and an FMV of \$1,000,000
- P sells Blackacre to a non-grantor trust (T) for the benefit of P’s children and takes back a ten-year installment note
- T receives a stepped-up basis for Blackacre
- T immediately sells Blackacre to an unrelated buyer for cash
- Little, if any gain, is recognized on the second sale
- T currently receives the full \$1,000,000 value of Blackacre in cash
- T makes installment payments to P, deferring gain recognition over a ten-year period



Taxable gain is deferred until payments on principal are made

Congress partially blocked this strategy in 1980 by enacting IRC § 453(e). This section provides as follows:

If—

(A) any person disposes of property to a related person (hereinafter in this subsection referred to as the “first disposition”), and

(B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the “second disposition”),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

If the original buyer receives the full value of the property on a second sale or other disposition in the first year, the amount treated as received by the original seller is the full amount received on the second sale. Because the purpose of IRC § 453(e) is to prevent the original buyer from receiving the transferred property before capital gains tax is recognized on it, however, the statute includes a limitation accelerating income recognition by the original seller in a taxable year only to the extent that the original buyer receives cash or other property during that year.

The term “*related person*” includes the same persons and entities described in the attribution rules of IRC § 318 and the related party rules of IRC § 267(b). Thus, it includes the original seller’s spouse, siblings, lineal descendants and ancestors. It also includes certain partnerships, trusts, estates and corporations.²⁴

Continuing Tax Planning Opportunity

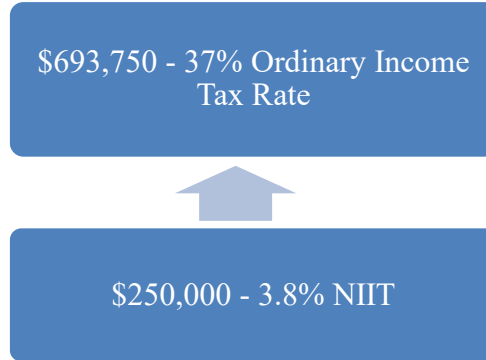
Except in the case of marketable securities, IRC § 453(e) only applies if the date of the second disposition is not more than two years from the date of the first disposition.²⁵ Thus, much of the economic benefit of mismatching receipt of income and gain recognition is still available if the original buyer is willing to hold the purchased property for more than two years before selling it.

Example 1. Parent (P) sells Greenacre, with a basis of \$500,000 and FMV of \$1,000,000 to a trust for P’s children (CT). P takes back a 10-year note calling for 10 annual principal payments of \$100,000 and adequate stated interest. CT’s basis in Greenacre is \$1,000,000, the amount of the note. In the first two years, CT makes payments of \$100,000 to P and P recognizes \$50,000 of gain on each payment. After making the second payment, T sells Greenacre to an unrelated party for \$1,000,000 and recognizes no gain because CT’s basis is equal to the selling price. CT has cashed out the full \$1,000,000 value of Greenacre even though P has paid tax on only \$100,000 of the gain. T will continue to pay off the note over the next eight years, gaining a substantial timing advantage.

Perhaps more importantly, a two-year installment sale can be used to smooth out income in order to reduce or eliminate exposure to the NIIT and higher tax brackets. The numbers shown apply to married taxpayers filing jointly.

²⁴ IRC § 453(f).

²⁵ IRC § 453(e)(2).



Example 2. In order to also illustrate the tax and income smoothing benefits of a two-year installment sale, assume the same facts as in Example 1, and also that P, married filing jointly, has taxable income of \$200,000. Consider the following two scenarios:

Scenario 1: P sells Greenacre to a third-party for \$1,000,000 in year one. Therefore, P will be taxed on the entire \$500,000 of gain in year one.

Total Gain in Year 1	\$500,000
\$50,000 Taxed @ 15%	\$7,500
\$246,600 Taxed @ 18.8%	\$46,361
\$203,400 Taxed @ 23.8%	<u>\$48,409</u>
Total After-Tax Gain (\$500,000-\$102,270)	<u>\$397,730</u>

Scenario 2: P sells Greenacre to CT (the trust for P's children) and takes back a 10-year installment note calling for 10 annual payments of \$100,000 with adequate interest. For the next 10 years, P receives \$100,000 (plus interest) and therefore, must recognize \$50,000 in gain each year.

Total Gain Each Year	\$50,000
Taxed @ 15%	\$7,500
10-Year Total Gain	\$500,000
10-Year Total Tax	<u>\$75,000</u>
Total After-Tax Gain	<u>\$425,000</u>

Two traps for the unwary should be noted. First, IRC § 453(e)(2) suspends the running of the two-year period for any time during which the related person's risk of loss is substantially diminished by (1) the holding of a put with respect to such property (or similar property), (2) the holding by another person of a right to acquire the property, or (3) a short sale or any other transaction.

Example 3. P makes an installment sale of Brownacre to T on September 1, 2022. On June 1, 2024 T enters into a contract to sell Brownacre to an unrelated buyer on December 1, 2024. The six months from June 1, 2022 to December 1, 2022 do not

count towards the two-year requirement. Thus, on December 1, 2024, T is treated as selling Brownacre only 21 months after the original sale by P, triggering application of IRC § 453(e).

Second, there is no two-year limitation period for a sale of marketable securities. Assuming that the original seller has not yet received all payments from the related party, IRC § 453(e) applies regardless of the time period between the two sales.

Disclosures

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