

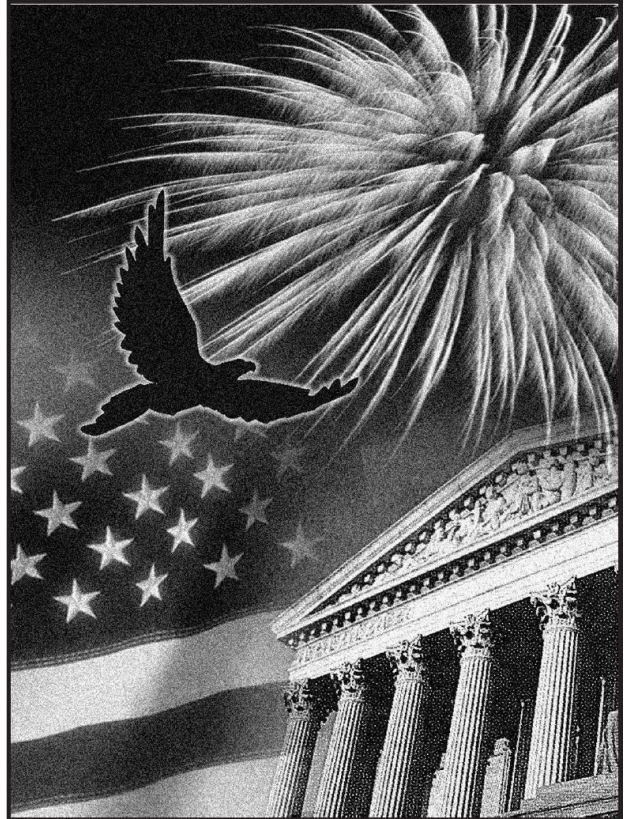
# Publication 537

## Installment Sales

For use in preparing

**2024** Returns

Volume 2 of 3



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# 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 2024, 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 2025 and the balance of \$700,000 (plus interest) in 2026.

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 2024 because the like-kind property you receive isn't treated as a payment for figuring gain. You report \$75,000 gain for 2025 (75% of \$100,000 payment received) and \$525,000 gain for 2026 (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 in which the sale or other disposition occurs, 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.

	<b>Parcels A and B</b>	<b>Parcel C</b>
FMV.....	\$120,000	\$10,000
Minus: Mortgage assumed.....	<u>30,000</u>	<u>-0-</u>
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.
  - a. 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, 2024, you sold the machine shop you'd operated since 2015. 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 2025. 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.

<b>Asset</b>	<b>FMV</b>	<b>Depreciation Claimed</b>	<b>Adj. Basis</b>
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.....	<u>6,500</u>	<u>18,624</u>	<u>5,376</u>
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.

	<b>Sale Price</b>	<b>Sale Exp.</b>	<b>Adj. Basis</b>	<b>Gain</b>
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 .	<u>18,500</u>	<u>925</u>	<u>-0-</u>	<u>17,575</u>
Total . . . .	<u>\$220,000</u>	<u>\$11,000</u>	<u>\$150,216</u>	<u>\$58,784</u>

The building was acquired in 2015, 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.

## **Installment**

	<b>Selling Price</b>	<b>Install- ment Sale Basis</b>	<b>Gross Profit</b>
Land . . . . .	\$42,000	\$17,100	\$24,900
Building . . . . .	48,000	38,400	9,600
Goodwill . . . . .	<u>18,500</u>	<u>925</u>	<u>17,575</u>
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% ( $\$52,075 \div \$108,500$ ). The gross profit percentage for each asset is figured as follows.

	<b><u>Percentage</u></b>
Land— $\$24,900 \div \$108,500..$	22.95
Building— $\$9,600 \div \$108,500..$	8.85
Goodwill— $\$17,575 \div \$108,500$	<u>16.20</u>
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 2024 is the down payment of \$100,000. The part of the payment for the installment sale is \$49,300 ( $\$100,000 \times 49.3\% (0.493)$ ). This amount is used in the installment sale computation.

**Installment income for 2024.** Your installment income for each asset is the gross profit percentage for that asset times \$49,300, the installment income received in 2024.

	Income
Land—22.95% of \$49,300 . . . . .	\$11,314
Building—8.85% of \$49,300 . . . . .	4,363
Goodwill—16.2% of \$49,300 . . . . .	7,987
Total installment income for 2024 . .	\$23,664

**Installment income after 2024.** You figure installment income for years after 2024 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 \$7,098,600 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.

**Internal Revenue Code sections 1274 and 483.** If an installment sale contract doesn't provide for adequate stated interest, generally either section 1274 or section 483 will apply to the contract. These sections recharacterize part of the stated principal amount as interest. Whether either of these sections applies to a particular installment sale contract depends on several factors, including the total selling price and the type of property sold.

***Determining whether section 1274 or section 483 applies.*** For purposes of determining whether section 1274 or section 483 applies to an installment sale contract, all sales or exchanges that are part of the same transaction (or related transactions) are treated as a single sale or exchange and all contracts arising from the same transaction (or a series of related transactions) are

treated as a single contract. Also, the total consideration due under an installment sale contract is determined at the time of the sale or exchange. Any payment (other than a debt instrument) is taken into account at its FMV.

## **Section 1274**

Section 1274 applies to a debt instrument issued for the sale or exchange of property if any payment under the instrument is due more than 6 months after the date of the sale or exchange and the instrument doesn't provide for adequate stated interest. Section 1274, however, doesn't apply to an installment sale contract that's a cash method debt instrument (defined next) or that arises from the following transactions.

- A sale or exchange for which the total payments are \$250,000 or less.
- The sale or exchange of an individual's main home.

- The sale or exchange of a farm for \$1 million or less by an individual, an estate, a testamentary trust, a small business corporation (defined in section 1244(c)(3)), or a domestic partnership that meets requirements similar to those of section 1244(c)(3).
- Certain land transfers between related persons (described later).

**Cash method debt instrument.** This is any debt instrument given as payment for the sale or exchange of property (other than new section 38 property) with a stated principal of \$5,070,500 (adjusted annually for inflation under section 1274A) or less if the following items apply.

1. The lender (holder) doesn't use an accrual method of accounting and isn't a dealer in the type of property sold or exchanged.

2. Both the borrower (issuer) and the lender jointly elect to account for interest under the cash method of accounting.
3. Section 1274 would apply except for the election in (2) above.

**Land transfers between related persons.**

The section 483 rules (discussed next) apply to debt instruments issued in a land sale between related persons to the extent the sum of the following amounts doesn't exceed \$500,000.

- The stated principal of the debt instrument issued in the sale or exchange.
- The total stated principal of any other debt instruments for prior land sales between these individuals during the calendar year.

The section 1274 rules, if otherwise applicable, apply to debt instruments issued in a sale of land to the extent the stated

principal amount exceeds \$500,000, or if any party to the sale is a nonresident alien.

Related persons include an individual and the members of the individual's family and their spouses. Members of an individual's family include the individual's spouse, brothers and sisters (whole or half), ancestors, and lineal descendants. Membership in the individual's family can be the result of a legal adoption.

## **Section 483**

Section 483 generally applies to an installment sale contract that doesn't provide for adequate stated interest and isn't covered by section 1274. Section 483, however, generally doesn't apply to an installment sale contract that arises from the following transactions.

- A sale or exchange for which no payments are due more than 1 year after the date of the sale or exchange.
- A sale or exchange for \$3,000 or less.

## **Exceptions to Sections 1274 and 483**

Sections 1274 and 483 don't apply under the following circumstances.

- An assumption of a debt instrument in connection with a sale or exchange or the acquisition of property subject to a debt instrument, unless the terms or conditions of the debt instrument are modified in a manner that would constitute a deemed exchange under Regulations section 1.1001-3.
- A debt instrument issued in connection with a sale or exchange of property if either the debt instrument or the property is publicly traded.
- A sale or exchange of all substantial rights to a patent, or an undivided interest in property that includes part or all substantial rights to a patent, if any amount is contingent on the productivity, use, or disposition of the property

transferred. See chapter 2 of Pub. 544 for more information.

- An annuity contract issued in connection with a sale or exchange of property if the contract is described in section 1275(a)(1)(B) and Regulations section 1.1275-1(j).
- A transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).
- A demand loan that is a below-market loan described in section 7872(c)(1) (for example, gift loans and corporation-shareholder loans).
- A below-market loan described in section 7872(c)(1) issued in connection with the sale or exchange of personal-use property. This rule applies only to the holder.



**More information.** For information on figuring unstated interest and OID and other special rules, see sections 1274 and 483 and the related regulations. In the case of an installment sale contract that provides for contingent payments, see Regulations sections 1.1275-4(c) and 1.483-4.

## **Disposition of an Installment Obligation**

A disposition generally includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation. An installment obligation is the buyer's note, deed of trust, or other evidence that the buyer will make future payments to you.

If you're using the installment method and you dispose of the installment obligation, generally you'll have a gain or loss to report. It's considered gain or loss on the sale of the property for which you received the installment obligation. If the original

installment sale produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss. If the original installment sale resulted in a section 1231 capital gain (or loss), the disposition of the obligation will result in either a long-term capital gain or an ordinary loss.

## **Rules To Figure Gain or Loss**

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

- If you sell or exchange the obligation, or you accept less than face value in satisfaction of the obligation, your gain or loss is the difference between your basis in the obligation and the amount you realize.

- If you dispose of the obligation in any other way, your gain or loss is the difference between your basis in the obligation and its FMV at the time of the disposition. This rule applies, for example, when you give the installment obligation to someone else or cancel the buyer's debt to you.

**Basis.** Figure your basis in an installment obligation by multiplying the unpaid balance on the obligation by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

**Example.** Several years ago, you sold property on the installment method. The buyer still owes you \$10,000 of the sale price. This is the unpaid balance on the buyer's installment obligation to you. Your gross profit percentage is 60%, so \$6,000 ( $60\%$  ( $0.60$ )  $\times$  \$10,000) is the profit owed you on

the obligation. The rest of the unpaid balance, \$4,000, is your basis in the obligation.

**Transfer between spouses or former spouses.** No gain or loss is recognized on the transfer of an installment obligation between spouses or former spouses if the transfer is incident to a divorce. A transfer is incident to a divorce if it occurs within 1 year after the date on which the marriage ends or is related to the end of the marriage. The same tax treatment of the transferred obligation applies to the transferee spouse or former spouse as would have applied to the transferor spouse or former spouse. The basis of the obligation to the transferee spouse (or former spouse) is the adjusted basis of the transferor spouse.

The nonrecognition rule doesn't apply if the spouse or former spouse receiving the obligation is a nonresident alien.

**Gift.** A gift of an installment obligation is a disposition. Your gain or loss is the difference between your basis in the obligation and its FMV at the time you make the gift.

For gifts between spouses or former spouses, see *Transfer between spouses or former spouses*, earlier.

**Cancellation.** If an installment obligation is canceled or otherwise becomes unenforceable, it's treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its FMV at the time you cancel it. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

**Forgiving part of the buyer's debt.** If you accept part payment on the balance of the buyer's installment debt to you and forgive the rest of the debt, you treat the settlement as a disposition of the installment obligation. Your gain or loss is the difference between

your basis in the obligation and the amount you realize on the settlement.

## **No Disposition**

The following transactions generally aren't dispositions.

**Reduction of selling price.** If you reduce the selling price but don't cancel the rest of the buyer's debt to you, it isn't considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to payments you receive after the reduction. See *Selling Price Reduced*, earlier.

**Assumption.** If the buyer of your property sells it to someone else and you agree to let the new buyer assume the original buyer's installment obligation, you haven't disposed of the installment obligation. It isn't a disposition even if the new buyer pays you a higher rate of interest than the original buyer.

**Transfer due to death.** The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller isn't a disposition. Any unreported gain from the installment obligation isn't treated as gross income to the decedent. No income is reported on the decedent's return due to the transfer. Whoever receives the installment obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been had the seller lived to receive the payments.

However, if an installment obligation is canceled, becomes unenforceable, or is transferred to the buyer because of the death of the holder of the obligation, it's a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related, the FMV of the installment obligation is considered to be no less than its full face value.

# Repossession

If you repossess your property after making an installment sale, you must figure the following amounts.

- Your gain (or loss) on the repossession.
- Your basis in the repossessed property.

The rules for figuring these amounts depend on the kind of property you repossess. The rules for repossessions of personal property differ from those for real property. Special rules may apply if you repossess property that was your main home before the sale. See Regulations section 1.1038-2 for further information.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. It doesn't matter how you repossess the property, whether you foreclose or the buyer voluntarily surrenders the property to you. However, it isn't a



repossession if the buyer puts the property up for sale and you repurchase it.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to you. The discharged obligation must be secured by the property you repossess. This requirement is met if the property is auctioned off after you foreclose and you apply the installment obligation to your bid price at the auction.

**Reporting the repossession.** You report gain or loss from a repossession on the same form you used to report the original sale. If you reported the sale on Form 4797, use it to report the gain or loss on the repossession.

## **Personal Property**

If you repossess personal property, you may have a gain or a loss on the repossession. In some cases, you may also have a bad debt.

To figure your gain or loss, subtract the total of your basis in the installment obligation and any repossession expenses you have from the FMV of the property. If you receive anything from the buyer besides the repossessed property, add its value to the property's FMV before making this calculation.

How you figure your basis in the installment obligation depends on whether or not you reported the original sale on the installment method. The method you used to report the original sale also affects the character of your gain or loss on the repossession.

**Installment method not used to report original sale.** The following paragraphs explain how to figure your basis in the installment obligation and the character of any gain or loss if you didn't use the installment method to report the gain on the original sale.

***Basis in installment obligation.*** If the issue price of the installment obligation is determined under section 1.1273-2 or section 1.1274-2, your basis will generally be the issue price of the obligation increased by any OID included in gross income and decreased by any payment other than a payment of qualified stated interest. Otherwise, your basis will be the amount realized attributable to the installment obligation increased by any unstated interest recognized in income under section 483 and decreased by any payment other than a payment of stated interest. If only part of the obligation is discharged by the repossession, figure your basis in only that part.

***Gain or loss.*** Add any repossession costs to your basis in the obligation. If the FMV of the property you repossess is more than this total, you have a gain. This is gain on the installment obligation, so it's all ordinary income. If the FMV of the repossessed

property is less than the total of your basis plus repossession costs, you have a loss. You included the full gain in income in the year of sale, so the loss is a bad debt. How you deduct the bad debt depends on whether you sold business or nonbusiness property in the original sale. See chapter 4 of Pub. 550 for information on nonbusiness bad debts and the instructions for your income tax return for information on business bad debts.

**Installment method used to report original sale.** The following paragraphs explain how to figure your basis in the installment obligation and the character of any gain or loss if you used the installment method to report the gain on the original sale.

***Basis in installment obligation.*** Multiply the unpaid balance of your installment obligation by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

***Gain or loss.*** If the FMV of the repossessed property is more than the total of your basis in the obligation plus any repossession costs, you have a gain. If the FMV is less, you have a loss. Your gain or loss on the repossession is of the same character (capital or ordinary) as your gain on the original sale.



Use Worksheet C to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

***Example.*** You sold your piano for \$1,500 in December 2023 for \$300 down and \$100 a month (plus interest). The payments began in January 2024. Your gross profit percentage is 40%. You reported the sale on the installment method on your 2023 income tax return. After the fourth monthly payment, the buyer defaulted on the contract (which has an unpaid balance of \$800) and you're forced to repossess the piano. The FMV of the piano on the date of repossession is \$1,400. The legal

costs of foreclosure and the expense of moving the piano back to your home total \$75. You figure your gain on the repossession as illustrated in Example—Worksheet C.

**Example—Figuring Gain or Loss on Worksheet C. Repossession of Personal Property**

**Note.** Use this worksheet only if you used the installment method to report the gain on the original sale.

1. Enter the FMV of the  
repossessed property 1,400
2. Enter the unpaid  
balance of the  
installment obligation 800
3. Enter your gross  
profit percentage for 40%  
the installment sale . (0.40)

4.	Multiply line 2 by line 3. This is your unrealized profit . . .	<u>320</u>
5.	Subtract line 4 from line 2. This is the basis of the obligation	<u>480</u>
6.	Enter your costs of repossessing the property . . . . .	<u>75</u>
7.	Add lines 5 and 6 . . .	<u>555</u>
8.	Subtract line 7 from line 1. This is your gain or loss on the repossession . . . . .	<u>845</u>

**Basis in repossessed property.** Your basis in repossessed personal property is its FMV at the time of the repossession.

**FMV of repossessed property.** The FMV of repossessed property is a question of fact to be established in each case. If you bid for the

property at a lawful public auction or judicial sale, its FMV is presumed to be the price it sells for, unless there's clear and convincing evidence to the contrary.

## **Real Property**

The rules for the repossession of real property allow you to keep essentially the same adjusted basis in the repossessed property you had before the original sale. You can recover this entire adjusted basis when you resell the property. This, in effect, cancels out the tax treatment that applied to you on the original sale and puts you in the same tax position you were in before that sale.

As a result, the total payments you've received from the buyer on the original sale must be considered income to you. You report, as gain on the repossession, any part of the payments you haven't yet included in income. These payments are amounts you previously treated as a return of your adjusted basis and excluded from income.



However, the total gain you report is limited. See Limit on taxable gain, later.

**Mandatory rules.** The rules concerning basis and gain on repossessed real property are mandatory. You must use them to figure your basis in the repossessed real property and your gain on the repossession. They apply whether or not you reported the sale on the installment method. However, they apply only if all of the following conditions are met.

1. The repossession must be to protect your security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. You can't pay any additional consideration to the buyer to get your property back unless either of the situations listed below applies.

- a. The requisition and payment of the additional consideration were provided for in the original contract of sale.
- b. The buyer has defaulted, or default is imminent.

Additional consideration includes money and other property you pay or transfer to the buyer. For example, additional consideration is paid if you reacquire the property subject to a debt that arose after the original sale.

***Conditions not met.*** If any one of these three conditions isn't met, use the rules discussed under Personal Property, earlier, as if the property you repossess were personal rather than real property. Don't use the rules for real property.

Worksheet C. **Figuring Gain or Loss on Repossession of Personal Property**

Keep for Your Records 

**Note.** Use this worksheet only if you used the installment method to report the gain on the original sale.

1.	Enter the FMV of the repossessed property .....	
2.	Enter the unpaid balance of the installment obligation .....	
3.	Enter your gross profit percentage for the installment sale .....	
4.	Multiply line 2 by line 3. This is your unrealized profit .....	
5.	Subtract line 4 from line 2. This is the basis of the obligation .....	
6.	Enter your costs of repossessing the property .....	
7.	Add lines 5 and 6 .....	
8.	Subtract line 7 from line 1. This is your gain or loss on the repossession .....	

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