

Reg. Section 15a.453-1(b)(2)(iii)

Installment method reporting for sales of real property and casual sales of personal property

(a) In general. Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method.

(b) Installment sale defined—

(1) In general. The term "installment sale" means a disposition of property (except as provided in paragraph (b)(4) of this section) where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term "installment sale" includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. For purposes of this paragraph, the taxable year in which payments are to be received is to be determined without regard to section 453(e) (relating to related party sales), section (f)(3) (relating to the definition of a "payment") and section (g) (relating to sales of depreciable property to a spouse or 80-percent-owned entity).

(2) Installment method defined—

(i) In general. Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the "gross profit ratio"). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(ii) Selling price defined. The term "selling price" means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price. See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.



(iii) Contract price defined. The term "contract price" means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section), assumed

or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted, for installment sales in taxable years ending after October 19, 1980, to reflect commissions and other selling expenses as provided in paragraph (b)(2)(v) of this section). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

- (iv) **Qualifying indebtedness.** The term "qualifying indebtedness" means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. The term "qualifying indebtedness" does not include an obligation of the taxpayer incurred incident to the disposition of the property (e.g., legal fees relating to the taxpayer's sale of the property) or an obligation functionally unrelated to the acquisition, holding, or operating of the property (e.g., the taxpayer's medical bill). Any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.
- (v) **Gross profit defined.** The term "gross profit" means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. Such additions to basis will not be deemed to affect the taxpayer's holding period in the transferred property.

(3) Payment—

- (i) **In general.** Except as provided in paragraph (e) of this section (relating to purchaser evidences of indebtedness payable on demand or readily tradable), the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property ("installment obligation"), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency). For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see §§ 1.1031(b)-2(b) and 1.1031(k)-1(j)(2)(iii) of this chapter. A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include amounts actually or constructively received in the taxable year under an installment obligation. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)-1(j)(2)(ii) of this chapter.

Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see § 1.1031(k)-1(j)(2)(i) of this chapter. Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences of indebtedness which are payable on demand or readily tradable. However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph (f) of this section (relating to transactions described in sections 351, 356(a) and 1031). Except as provided in § 15a.453-2 of these regulations (relating to distributions of installment obligations in corporate liquidations described in section 337), payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section) assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property (determined after adjustment to reflect selling expenses). For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (e.g., a novation) shall be treated as an assumption of the qualifying indebtedness. If the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment. To the extent that cancellation is not in consideration of the sale, see §§ 1.61-12(b)(1) and 1.1001-2(a)(2) relating to discharges of indebtedness. If the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.

- (ii) Wrap-around mortgage. This paragraph (b)(3)(ii) shall apply generally to any installment sale after March 4, 1981 unless the installment sale was completed before June 1, 1981 pursuant to a written obligation binding on the seller that was executed on or before March 4, 1981. A "wrap-around mortgage" means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property ("wrapped indebtedness") and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's

basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. For purposes of this paragraph (b)(3)(ii), the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale. Therefore, except as otherwise required by section 483 or 1232, the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

(iii) Standby letter of credit. The term "standby letter of credit" means a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Whether or not the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

(4) Exceptions. The term "installment sale" does not include, and the provisions of section 453 do not apply to, dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan, or to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year. See section 453A and the regulations thereunder for rules relating to installment sales by dealers in personal property. A dealer in real property or a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.

(5) Examples. The following examples illustrate installment method reporting under this section:

Example (1). In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for \$100,000: \$10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is \$38,000. Selling expenses paid by A are \$2,000. Therefore, the gross profit is \$60,000 (\$100,000 selling price - \$40,000 basis inclusive of selling expenses). The gross profit ratio is $\frac{3}{5}$ (gross profit of \$60,000 divided by \$100,000 contract price). Accordingly, \$6,000 $\frac{3}{5}$ of \$10,000) of each \$10,000

payment received is gain attributable to the sale and \$4,000 (\$10,000 - \$6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.

Example (2). C sells Whiteacre to D for a selling price of \$160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of \$60,000. D will assume or take subject to the \$60,000 mortgage and pay the remaining \$100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is \$90,000. There are no selling expenses. The contract price is \$100,000, the \$160,000 selling price reduced by the mortgage of \$60,000 assumed or taken subject to. Gross profit is \$70,000 (\$160,000 selling price less C's basis of \$90,000). C's gross profit ratio is 7/10 (gross profit of \$70,000 divided by \$100,000 contract price). Thus, \$7,000 (7/10 of \$10,000) of each \$10,000 annual payment is gain attributable to the sale, and \$3,000 (\$10,000 - \$7,000) is recovery of basis.

Example (3). The facts are the same as in example (2), except that C's basis in the land is \$40,000. In the year of the sale C is deemed to have received payment of \$20,000 (\$60,000 - \$40,000, the amount by which the mortgage D assumed or took subject to exceeds C's basis). Since basis is fully recovered in the year of sale, the gross profit ratio is 1 (\$120,000/\$120,000) and C will report 100% of the \$20,000 deemed payment in the year of sale and each \$10,000 annual payment as gain attributable to the sale.

Example (4). E sells Blackacre, an unencumbered capital gain property in E's hands, to F on January 2, 1981. F makes a cash down payment of \$500,000 and issues a note to E obliging F to pay an additional \$500,000 on the fifth anniversary date. The note does not require a payment of interest. In determining selling price, section 483 will apply to recharacterize as interest a portion of the \$500,000 future payment. Assume that under section 483 and the applicable regulations \$193,045 is treated as total unstated interest, and the selling price is \$806,955 (\$1 million less unstated interest). Assuming E's basis (including selling expenses) in Blackacre is \$200,000 gross profit is \$606,955 (\$806,955 - \$200,000) and the gross profit ratio is 75.21547%. Accordingly, of the \$500,000 cash down payment received by E in 1981, \$376,077 (75.21547% of \$500,000) is gain attributable to the sale and \$123,923 is recovery of basis (\$500,000 - \$376,077).

Example (5). In 1982, G sells to H Blackacre, which is encumbered by a first mortgage with a principal amount of \$500,000 and a second mortgage with a principal amount of \$400,000, for a selling price of \$2 million. G's basis in Blackacre is \$700,000. Under the agreement between G and H, passage of title is deferred and H does not assume and purportedly does not take subject to either mortgage in the year of sale. H pays G \$200,000 in cash and issues a wrap-around mortgage note with a principal amount of \$1,800,000 bearing adequate stated interest. H is deemed to have acquired Blackacre subject to the first and second mortgages (wrapped indebtedness) totalling \$900,000. The contract price is \$1,300,000 (selling price of \$2 million less \$700,000 mortgages within the seller's basis assumed or taken subject to). Gross profit is also \$1,300,000 (selling price

of \$2 million less \$700,000 basis). Accordingly in the year of sale, the gross profit ratio is 1 (\$1,300,000/\$1,300,000). Payment in the year of sale is \$400,000 (\$200,000 cash received plus \$200,000 mortgage in excess of basis (\$900,000 - \$700,000)). Therefore, G recognizes \$400,000 gain in the year of sale (\$400,000 x 1). In the hands of G the wrap-around installment obligation has a basis of \$900,000, equal to G's basis in Blackacre (\$700,000) increased by the gain recognized by G in the year of sale (\$400,000) reduced by the cash received by G in the year of sale (\$200,000). G's gross profit with respect to the note is \$900,000 (\$1,800,000 face amount less \$900,000 basis in the note) and G's contract price with respect to the note is its face amount of \$1,800,000. Therefore, the gross profit ratio with respect to the note is 1/2 (\$900,000/\$1,800,000).

Example (6). The facts are the same as example (5) except that under the terms of the agreement H assumes the \$500,000 first mortgage on Blackacre. H does not assume and purportedly does not take subject to the \$400,000 second mortgage on Blackacre. The wrap-around installment obligation issued by H to G has a face amount of \$1,300,000. The tax results in the year of sale to G are the same as example (5) (\$400,000 payment received and gain recognized). In the hands of G, basis in the wrap-around installment obligation is \$400,000 (\$700,000 basis in Blackacre plus \$400,000 gain recognized in the year of sale minus \$700,000 (\$200,000 cash received and \$500,000 treated as cash received as a result of H's assumption of the first mortgage)). G's gross profit with respect to the note is \$900,000 (\$1,300,000 face amount of the wrap-around installment obligation less \$400,000 basis in that note) and G's contract price with respect to the note is its face value of \$1,300,000. Therefore, the gross profit ratio with respect to the note is 9/13 (\$900,000/\$1,300,000).

Example (7). A sells the stock of X corporation to B for a \$1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit (within the meaning of paragraph (b)(3)(iii) of this section) issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct lien upon or other security interest in such cash or cash equivalent collateral. Receipt of B's installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

Example (8). The facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of \$600,000. To secure fully its \$1 million note issued to A, B deposits in escrow \$400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B's installment obligation will be treated as the receipt payment by A in the sum of \$400,000.