CHAPTER 40

Sales, Installment Sales, and Self-Canceling Installment Notes

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SALES

A sale is an asset transfer from you to a third party (someone other than your spouse) for consideration. Consideration is, alone or in any combination, cash, a promissory note, or relief from existing debt. The problem with a sale is if you receive more than your adjusted tax basis in return for the assets you are selling, you will be subject to tax. If you have held the asset for less than one year, the gain will be classified as a short-term capital gain. If instead, you have held the asset for one year or more, the gain will then be classified as long-term capital and will be taxed at a somewhat lower rate. If the sale involves a depreciable asset, the sale may be subject to depreciation recapture, which like a short-term capital gain, will be taxed at ordinary income tax rates. A taxpayer's original basis in a depreciable asset will diminish over time as the taxpayer depreciates the asset. A classic example of a sale that may generate depreciation recapture is the sale of rental property.

In a sale, all the gain is recognized at once, and accordingly, all tax on the recognized gain will be due by April 15th of the year following the year of the sale. If the gain is large enough you may find the Alternative Minimum Tax (AMT) will be owed instead of long-term capital gains. If the debt owed on the asset sold is large enough, and the tax burden created by the sale is large enough, you can possibly find yourself in the unwelcome position of owing more than you actually received from the sale.

INSTALLMENT SALES

An installment sale is a sale by which some or all of the payments are made over more than one calendar (tax) year. As the seller, you will have receive a promissory note in addition to any other consideration. The benefit of spreading the payments out over time is that the tax on the gain is likewise spread out over time.

In an installment sale, the total gain for the sale will be the sales price minus your adjusted tax basis. Dividing the gain by the sales price yields the gross profit percentage. The gain you will recognize for each payment will be the principal payment multiplied by the gross profit percentage. The IRS has established rules as to the minimum rate of interest that must be charged. These rates are updated monthly and are known as the applicable federal rate (AFR). Loans at rates below the appropriate AFR will create imputed interest, on which you must pay tax, even though none, or only a part, was actually paid.

For sales to relatives, it is important that the assets be sold for "full and adequate consideration" in order to avoid adverse gift tax consequences. Sales for less than full and adequate consideration will result in the sale to be categorized as a gift. To avoid a taxable gift, the transaction must be properly documented, and the principal amount of the note must be equivalent to the fair market value of the assets being sold.

The primary risk in an installment sale is that the note may never be paid off in full. Any unpaid principal remaining upon the transferor's death will remain in the transferor's taxable estate. If the purpose of the sale was to convert otherwise illiquid assets into a steady income stream, that purpose will be thwarted if the payments cease. Therefore, the transfer or will always need to consider the credit risk of the transferee.

Self-Canceling Installment Note

A self-canceling installment note (SCIN) is used in an installment sale where the seller agrees that any balance remaining on the note is automatically canceled upon his or her death. This means the unpaid balance on the note is not includable in the transferor's estate. Accordingly, an appropriate risk premium is added to the promissory note in a SCIN to account for the possibility that the full value of the note may never be paid. This may be done by increasing the amount of the principal to be paid, or by increasing the interest rate above the AFR rate. You should consult a professional to calculate the appropriate premium for either principal or income because the rules concerning this transaction are complex.

Estate Planning Uses of Installment Sales and SCINs

An installment sale can be a good way for parents to remove assets from their estates and transfer them to their children or other beneficiaries. Payments on the note can be used to satisfy the parents' income requirements during the term of the note. If interest rates are low and income requirements are likewise low, the note could call for interest-only payments with a balloon payment at the end of the term, which makes the purchase very affordable in most cases. Installment sales can also be a good way for parents to transfer illiquid closely held business interests to their children, in which case, the utility of the installment sale may be heightened by leveraging discounts on the assets transferred due to transfer restrictions and illiquidity.

Another good use for an installment sale in the estate planning context is a sale to an intentionally defective grantor trust (IDGT) for the benefit of the seller's children. During the seller's lifetime, there is no income tax due on the sale. However, for income tax purposes, the seller will continue to be taxed on income generated by the asset. The payment of income tax on earnings is effectively a tax-free gift to the children, which substantially increases the total wealth transferred. There is a difference of opinion among tax practitioners about whether or not the accrued gain on the assets sold will need to be recognized if the principal amount due is cancelled due to the seller's death.

Henry C. Weatherby, JD, ChFC, CLU, CEBS, focuses on Business, Estate Planning, Elder Law, Estate and Trust Settlement. Value to clients comes from being a concerned, informed, thoughtful advisor.