

# AG TAX TIDBITS

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## Installment Sale to a Related Party

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An installment sale is the disposal of property where the seller receives at least one payment after the tax year of sale. The installment method cannot be used to report a loss. Utilizing installment sales allow cash-basis taxpayers to report portions of gain to multiple tax years as the installment payments are received. For the installment sale provision – spouses, children, grandchildren, brothers, sisters, and parents are related persons. Additionally, a partnership or corporation in which the taxpayer has a controlling interest, or an estate or trust with which the taxpayer has a connection, can also be considered a related party. Two special rules apply to an installment sale between related parties.

**Rule #1:** This rule applies when property sold and reported under the installment method to a related party – is disposed of within 2 years of the first sale. This rule requires the original seller to report gain on the property disposed of by the related party in the year of the second disposition – whether or not the installment payments to the original seller are accelerated.

**Exception to Rule #1:** The provisions of this rule will not apply if the taxpayer can show, to the satisfaction of the IRS, that neither of the dispositions (first and second) had tax avoidance as one of the principal purposes for the disposal. Involuntary conversion is a type of disposition that will generally qualify as an exception. Another possible exception is when the disposition is also an installment sale with terms that are substantially equal or longer than those of the first sale.

**Rule #2:** Unless the exception provided below applies, the sale of depreciable property to a related party cannot be reported using the installment method. Depreciable property, for this provision, is considered any property the purchaser can depreciate.

**Exception to Rule #2:** The seller may use the installment method if they can show to the IRS's satisfaction tax avoidance was not one of the principal purposes of the sale.

A depreciation recapture rule, with or without a related party, requires the recapture of depreciation for Section 1245 (personal property) and Section 1250 (real property) assets as ordinary income in the year of sale. Thus, the installment method of reporting sales of

depreciable property will normally be advantageous only if the sale price is substantially greater than the original cost.

Important Note: Raised breeding livestock sold to a related party would be captured under Rule #2 – since the breeding livestock would be depreciable by the purchaser.



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