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Reviewed: May 2001

Minimum Interest Rates on Land Installment Sale Contracts

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Once upon a time taxpayers finagled interest rates from extreme highs to extreme lows to best serve the tax savings of the stronger party negotiating an installment sales contract. For example, a higher selling price with a lower interest rate resulted in more capital gain and less ordinary income for a seller, while a lower selling price with a higher interest rate resulted in greater tax savings for a purchaser. In 1984 the Internal Revenue Code put brakes on this finagling by adding the “below market rate” and “imputed interest” provisions. These provisions utilize “applicable federal rates (AFR)” which serve as a the minimum (test) interest rate for calculating interest paid and interest received, if the contract utilizes an interest rate less than the appropriate AFR. If the contract interest rate is less than the AFR, the imputed interest rules require the lender to recognize interest income at the AFR rate and provide for the borrower to deduct the AFR calculated interest (if the interest expense is deductible).

Applicable Federal rates are published on a monthly basis – providing applicable rates for short, mid, and long-term loans. Additionally, AFR (also known as safe harbor rates) are provided for monthly, quarterly, semi-annual, and annual compounding. The AFR for June 2001 are as follows:

	Annual	Semi-annual	Quarterly	Monthly
Short-term	4.15%	4.11%	4.09%	4.08%
Mid-term	5.02%	4.96%	4.93%	4.91%
Long-term	5.75%	5.67%	5.63%	5.60%

The short-term AFR is for loans with terms of 3 years or less. The mid-term is for loans with terms over 3 years, but not over 9 years. The long-term AFR is for loans with terms of over 9 years.

IRS Code provisions provide an exception to the imputed interest rules for land transfers between related persons to the extent the sum of the following amounts do not exceed \$500,000.

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

Additionally, the exception provisions for related persons provides that regardless of how high the AFR might be, the test rate (applicable rate) will not be more than 6% compounded semi-annually on the land installment contract amount or \$500,000 which ever is less.

The applicable federal rates are published by the IRS each month in the *Internal Revenue Bulletin*. The *Internal Revenue Bulletins* are available on the web at http://www.irs.gov/ind_info/bullet.html. Additionally, your accountant and/or tax consultant should have resources that publish the applicable federal rates.



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