



Department
of the
Treasury

Internal
Revenue
Service

Publication 537
Cat. No. 15067V

Installment Sales

For use in preparing
1998 Returns



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Contents

Introduction	1
What Is an Installment Sale?	2
General Rules	2
Figuring Installment Income	2
Reporting Installment Income	3
Other Rules	3
Electing Out of Installment Method	3
Payments Received	4
Escrow Account	5
Depreciation Recapture Income	5
Sale to Related Person	5
Like-Kind Exchange	6
Contingent Payment Sale	6
Single Sale of Several Assets	6
Sale of a Business	7
Unstated Interest	8
Disposition of Installment Obligation	9
Repossession	10
Reporting an Installment Sale	11
How To Get More Information	16
Index	17

Introduction

An installment sale is a sale of property where you receive at least one payment after the close of the tax year of the sale. If you dispose of property in an installment sale, you report part of your gain or profit when you receive each installment payment. You cannot use the installment method to report a loss.

This publication discusses the general rules that apply to all installment sales. It also discusses more complex rules that apply only when certain conditions exist or certain types of property are sold. There are two examples of reporting installment sales on Form 6252 at the end of the publication.

If you sold your home or other nonbusiness property under an installment plan, you will need to read only the *General Rules*. If you sold business or rental property or had a like-kind exchange or other complex situation, see the appropriate discussion under *Other Rules*.

If you sold your entire interest in a passive activity, special rules apply to the treatment of passive activity losses. Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate or have a rental activity. See Publication 925 for information on this topic.

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 541** Partnerships
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 551** Basis of Assets
- 925** Passive Activity and At-Risk Rules

Form (and Instructions)

6252 Installment Sale Income

See *How To Get More Information* near the end of this publication for information about getting these publications and the form.

What Is an Installment Sale?

An installment sale is a sale of property where you receive at least one payment after the close of the tax year of the sale. The installment sale rules do not apply to the regular sale of inventory. See *Sale of a Business* under *Other Rules*.

If a sale qualifies as an installment sale, you must report the gain on the sale under the installment method unless you elect to recognize gain under your regular method of accounting. Under the installment method, you report prorated gain on the sale only as payments are received. It does not matter whether you use the cash or accrual method of accounting. For information on recognizing the entire gain in the year of sale, see *Electing Out of Installment Method* under *Other Rules*, later.



TIP If you finance the purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.

General Rules

The buyer's "installment obligation" to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you. The rules discussed in this publication generally apply regardless of the form of the installment obligation.

Stock or securities. You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain on the sale in the year in which the trade date falls.

Dealer sales. Sales of personal property by a person who regularly sells or otherwise disposes of the same type of property on the installment plan cannot be reported under the installment method. This also applies to real property held for sale to customers in the ordinary course of a trade or business. However, this does not apply to an installment sale of property used or produced in farming.

Special rule. Dealers of timeshares and residential lots can report certain sales on the installment method if they elect to pay a special interest charge. For more information, see section 453(l) of the Internal Revenue Code.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

Unstated interest. If your sale calls for payments in a later year and the sales contract provides for little or no interest, you may have to figure unstated interest, even if you have a loss. See *Unstated Interest*, later.

Figuring Installment Income

Each payment on an installment sale usually consists of the following three parts.

- 1) Interest income.
- 2) Return of your adjusted basis in the property.
- 3) Gain on the sale.

In each year you receive a payment, you must include the interest part in income, as well as the part that is your gain on the sale. You do not include in income the part that is the return of your basis in the property.

Interest income. You must report interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See *Unstated Interest*, later.

Return of basis and gain on sale. The rest of each payment is treated as if it were made up of two parts. One part is a tax-free return of your adjusted basis in the property. The other part is your gain.



Figuring gain part of payment. To figure what part of any payment is gain, multiply the payment (less interest) by the gross profit percentage. Use the following worksheet to figure the gross profit percentage.

1) Selling price	_____
2) Installment sale basis:	
Adjusted basis of property ...	_____
Selling expenses	_____
Depreciation recapture	_____
3) Gross profit (line 1 - line 2)	_____
4) Contract price	_____
5) Gross profit percentage (line 3 ÷ line 4)	_____

Selling price. The selling price is the total cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. Fair market value (FMV) is discussed later under *Payment of property*. It also includes any debt the buyer pays, assumes, or takes, to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Installment sale basis. This publication refers to the adjusted basis plus selling expenses and depreciation recapture income (see *Other Rules*) as the installment sale basis.

Adjusted basis. Basis is a way of measuring your investment in the property you are selling. The way you figure basis depends on how you first acquired the property. The basis of property you bought is generally its cost. The basis of property you inherited,

received as a gift, built yourself, or received in a tax-free exchange is figured differently.

While you own personal-use property, various events may change your original basis in the property. Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as deductible casualty losses or depreciation previously allowed or allowable, decrease basis. The result is adjusted basis.

For more information on how to figure basis and adjusted basis, see Publication 551.

Selling expenses. Selling expenses are any expenses that relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property.

Depreciation recapture. If you took depreciation deductions on the asset, part of the gain on the sale of the asset may be recaptured as ordinary income. See the discussion of depreciation recapture under *Other Rules*, later.

Gross profit. For an installment sale, gross profit is the total gain you report on the installment method.

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See *Sale of your home*, later, under *Reporting Installment Income*.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments Received*, later.

If part of the selling price is paid in cash and you hold a mortgage payable from the buyer to you for the remainder, then the contract price equals the selling price.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. It is called the "gross profit percentage" and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see the example under *Selling price reduced*, later, for a situation where the gross profit percentage changes.

Example. You sell property at a contract price of \$2,000 and your gross profit is \$500. Your gross profit percentage is 25% ($\$500 \div \$2,000$). After subtracting interest, you report as gain from the sale, 25% of each payment, including the down payment, for the tax year you receive the payment.

Amount to include in income. Each year you receive a payment on the installment sale, multiply the payment (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year. In certain circumstances, you may be considered to have received a payment, even though you received nothing directly. In addition to cash, a receipt of property or the assumption of your mortgage on the property sold may be considered a payment. For a detailed discussion, see *Payments Received* under *Other Rules*, later.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure

your gross profit percentage for the remaining payments. Refigure your gross profit using the reduced sale price and then subtract the gain already reported. Spread the remaining gain over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1996, you sold land with a basis of \$40,000 for \$100,000. Your gross profit was \$60,000. You received a \$20,000 down payment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 12% interest, beginning in 1997. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1996 and 1997.

In 1998, you and the buyer agreed to reduce the purchase price to \$85,000 and payments during 1998, 1999, and 2000 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured as follows.

1) Reduced selling price	\$85,000	
2) Minus: Basis	40,000	
3) Adjusted gross profit	\$45,000	
4) Minus: Gain reported in 1996 & 1997 ..	24,000	
5) Gain to be reported	\$21,000	
6) Selling price to be received:		
Reduced selling price	\$85,000	
Minus: Payments received		
in 1996 and 1997	40,000	\$45,000
7) New gross profit percentage		
(line 5 ÷ line 6)	46.67%	

You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 1998, 1999, and 2000.

Reporting Installment Income

Form 6252. You must use Form 6252 to report a sale of property as an installment sale. Use the form to report the sale in the year it takes place and to report payments received in later years. Attach it to your tax return for each year.

Form 6252 will help you determine the gross profit, contract price, gross profit percentage, and how much of each payment received during the tax year to include in income.

Form 6252 is divided into the following parts.

- 1) Part I, *Gross Profit and Contract Price*, is completed for the year of sale.
- 2) Part II, *Installment Sale Income*, is completed for the year of sale and for any year you receive a payment or are considered to have received a payment.
- 3) Part III, *Related Party Installment Sale Income*, is completed if you sold the property to a related person, as discussed later under *Sale to Related Person*.

Year of sale. Answer the questions at the beginning of the form and complete Part I and Part II. Question 3 asks whether you sold the property to a related party. If you answer "Yes," answer question 4 and complete Part III.

Later years. Answer the questions at the beginning of the form and complete Part II for each year in which you receive a payment on the sale. If you sold the property to a related

person, you may have to complete Part III also.

Schedule D (Form 1040). Enter the gain figured on Form 6252 for personal-use property (capital assets) on Schedule D (Form 1040), *Capital Gains and Losses*. If your gain from the installment sale qualifies for long-term capital gain treatment in the year of sale, it will continue to qualify in later tax years. Your gain is long-term if you owned the property for more than one year when you sold it.

Form 4797. An installment sale of property used in your business or that earns rent or royalty income may result in a capital gain, an ordinary gain, or both. All or part of any gain from its disposition may be ordinary gain from depreciation recapture. Use Form 4797 to report these transactions and to determine the ordinary or capital gain or loss.

Sale of your home. If you sell your home, you may be able to exclude all or part of the gain on the sale. See Publication 523 for information about excluding the gain. If the sale is an installment sale, any gain you exclude is not included in gross profit when figuring your gross profit percentage.

Seller-financed mortgage. Special reporting procedures apply if you finance the sale of your home to an individual.

When you report interest income received from a buyer who uses the property as a personal residence, write the buyer's name, address, and social security number (SSN) on line 1 of Schedule B (Form 1040) or Schedule 1 (Form 1040A).

When deducting the mortgage interest, the buyer must write your name, address, and SSN on line 11 of Schedule A (Form 1040).

If either person fails to include the other person's SSN, a \$50 penalty may apply.

Other Rules

The rules discussed in this part of the publication apply only in certain circumstances or to certain types of property. The rules cover the following topics.

- 1) Electing out of the installment method.
- 2) Payments received, including those considered received.
- 3) An escrow account.
- 4) Depreciation recapture income.
- 5) A sale to a related person.
- 6) A like-kind exchange.
- 7) A contingent payment sale.
- 8) A single sale of several assets.
- 9) The sale of a business.
- 10) Unstated interest.
- 11) Disposition of an installment obligation.
- 12) A repossession.

Electing Out of Installment Method

You must use the installment method to report an installment sale unless you elect not to use that method. If you make the election, you generally report the entire gain in the year

of sale, even though you will not be paid all of the selling price in that year.

To figure the gain to report, use the FMV of the buyer's installment obligation. Notes, mortgages, and land contracts are examples of obligations that are included at FMV.

You must figure the FMV of the buyer's installment obligation, whether or not you would actually be able to sell it. If you use the cash method of accounting, the FMV of the obligation will never be considered less than the FMV of the property sold (minus any other consideration received). If you use an accrual method of accounting, you must always use the full face value of the installment obligation as its FMV.

Example. You sold a parcel of land for \$50,000. You received a \$10,000 down payment and will receive the balance over the next 10 years at \$4,000 a year, plus 8% interest. The buyer gave you a note for \$40,000. The note had an FMV of \$40,000. You paid a commission of 6%, or \$3,000, to a broker for negotiating the sale. The land cost \$25,000 and you owned it for more than one year. You decide to elect out of the installment method and report the entire gain in the year of sale.

Gain realized:

Selling price	\$50,000
Minus: Property's adj. basis	25,000
Commission	3,000
Gain realized	<u>\$22,000</u>

Gain recognized in year of sale:

Cash	\$10,000
Market value of note	40,000
Total realized in year of sale	\$50,000
Minus: Property's adj. basis	25,000
Commission	3,000
Gain recognized	<u>\$22,000</u>

The recognized gain of \$22,000 is long-term capital gain. Since you include the entire gain in income in the year of sale, you do not include in income any principal payments you receive in later tax years. The interest on the note is ordinary income and is reported as interest income each year.

How to elect out. To make this election, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever applies.

When to elect out. Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place. Once made, the election generally cannot be revoked. However, you can apply to the IRS to revoke the election not to use the installment method. You will not be allowed to revoke the election if either of the following situations applies.

- 1) One of the purposes is to avoid federal income tax.
- 2) The tax year in which any payment was received has closed.

You may qualify for an automatic extension of six months from the due date of the return, **excluding extensions**, to make this election. See Regulations sections 301.9100-2(b) and (d) for more information. You can read the full text of these provisions at some IRS offices and public libraries.

Payments Received Including Payments Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments include the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission.

Buyer pays seller's expenses. If the buyer pays any of your expenses related to the sale of your property, it is considered a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer assumes mortgage. If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to the mortgage, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with an adjusted basis of \$19,000. You have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you \$10,000 (a cash down payment of \$2,000 and \$2,000 (plus 8% interest) in each of the next 4 years).

The selling price is \$25,000 (\$15,000 + \$10,000). Your gross profit is \$5,000 (\$25,000 - \$20,000 installment sale basis). The contract price is \$10,000 (\$25,000 - \$15,000 mortgage). Your gross profit percentage is 50% (\$5,000 ÷ \$10,000). You report half of each \$2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. Add to this amount the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale.

If the mortgage the buyer assumes is equal to or more than your installment sale basis in the property, the gross profit percentage will always be 100%.

Example. The selling price for your property is \$9,000. The buyer will pay you \$1,000 annually (plus 8% interest) over the next 3 years and assume an existing mortgage of \$6,000. Your adjusted basis in the property is \$4,400. You have selling ex-

penses of \$600, for a total installment sale basis of \$5,000. The part of the mortgage that is more than your installment sale basis is \$1,000 (\$6,000 - \$5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is \$4,000:

Selling price	\$9,000
Minus: Mortgage	(6,000)
Amount actually received	<u>\$3,000</u>
Add difference:	
Mortgage	\$6,000
Less: Installment sale basis	<u>5,000</u>
Contract price	<u>\$4,000</u>

Your gross profit on the sale is also \$4,000:

Selling price	\$9,000
Minus: Installment sale basis	(5,000)
Gross profit	<u>\$4,000</u>

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. Treat the \$1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

Mortgage canceled. If the buyer of your property is the person who holds the mortgage on it, your debt is canceled, not assumed. You are considered to receive a payment equal to the outstanding canceled debt.

Example. Mary Jones loaned you \$4,500 in 1994 in exchange for a note mortgaging a tract of land you owned. On April 4, 1998, she bought the land for \$7,000. At that time, \$3,000 of her loan to you was outstanding. She agreed to forgive this \$3,000 debt and to pay you \$2,000 (plus interest) on August 1, 1998, and August 1, 1999. She did not assume an existing mortgage. She canceled the \$3,000 debt you owed her. You are considered to have received a \$3,000 payment at the time of the sale.

Buyer assumes other debts. If the buyer assumes your other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under *Buyer assumes mortgage*. However, they apply to only the following two types of debts the buyer assumes.

- 1) Those acquired from ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes.
- 2) Those acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of sale.

Payment of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Like-Kind Exchange*, later. The value of the payment is the property's FMV on the date you receive it.

Fair market value (FMV). This is the price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having a reasonable knowledge of all necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its FMV.

Third-party note. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's FMV. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on your sale.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$5,000, 8% note of a third party. The FMV of the third-party note at the time of your sale was \$3,000. This amount, not \$5,000, is a payment to you in the year of sale. Because the third-party note had an FMV equal to 60% of its face value (\$3,000 ÷ \$5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. Report the interest you receive in full as ordinary income.

Bond. A bond or other evidence of debt you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's FMV. Accrual basis taxpayers should see Regulations section 15A.453-1(e)(2).

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. Its full face value is included when figuring the selling price and the contract price. Payments you receive on the note are used to figure your gain in the year you receive them.

Guarantee. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is known as the pledge rule and it applies if the selling price of the property was over \$150,000. It does not apply to the following dispositions.

- 1) Sales of property used or produced in farming.
- 2) Sales of personal-use property.
- 3) Qualifying sales of timeshares and residential lots.

The net debt proceeds are the gross debt minus the direct expenses of getting the debt. The amount treated as a payment is consid-

ered received on the later of either of the following dates.

- 1) The date the debt becomes secured.
- 2) The date you receive the debt proceeds.

A debt is secured by an installment obligation to the extent that payment of principal or interest on the debt is directly secured (under the terms of the loan or any underlying arrangement) by any interest in the installment obligation.

Limit. The net debt proceeds treated as a payment on the pledged installment obligation cannot be more than the excess of the amount in item 1 over the amount in item 2, below.

- 1) The total contract price on the installment sale.
- 2) Any payments received on the installment obligation before the date the net debt proceeds are treated as a payment.

Installment payments. The pledge rule accelerates the reporting of the installment obligation payments. Do not report payments received on the obligation after it has been pledged until the payments received are more than the amount reported under the pledge rule.

Exception. The pledge rule does not apply to debt incurred after December 17, 1987, to refinance a debt under the following circumstances.

- 1) The debt was outstanding on December 17, 1987.
- 2) The debt was secured by that installment sale obligation on that date and at all times thereafter until the refinancing occurred.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt if a person other than the creditor or a person related to the creditor provides the refinancing.

This exception applies only to the refinancing that does not exceed the principal of the original debt immediately before the refinancing. Any excess is treated as a payment on the installment obligation.

Escrow Account

In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. Generally, these sales cannot be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

Example. You sell property for \$10,000. The sales agreement calls for a down payment of \$1,000 and payment of \$1,500 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. You cannot report the sale on the installment method because the full purchase price is considered received in the year of sale. You must report the entire gain in the year of sale.

Escrow established in a later year. If you make an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation. Therefore, you cannot use the installment method to report any payments you receive from the escrow account.

Substantial restriction. If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer.

Depreciation Recapture Income

If you sell property for which you claimed depreciation deductions, report any depreciation recapture income in the year of sale, whether or not an installment payment was received that year. Figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of **Form 4797**. Report the recapture income in Part II of **Form 4797** as ordinary income in the year of sale. The recapture income is also included in Part I of **Form 6252**. However, the gain equal to the recapture income is not reported on the installment method. Report any gain greater than the recapture income on the installment method. For more information on depreciation recapture, see chapter 3 in Publication 544.

The ordinary recapture income reported in the year of sale is included in your installment sale basis in determining your gross profit on the installment sale. See the discussion under *General Rules*, earlier.

Sale to Related Person

Two special rules apply to an installment sale between related persons. Test your sale against Rule 1 first. If Rule 1 does not apply, test your sale against Rule 2. For purposes of these rules, spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation in which you have an interest, or an estate or trust with which you have a connection, can also be considered a related person.

For more information on these kinds of sales, see section 453 of the Internal Revenue Code.

Rule 1—Sale of Depreciable Property

If you sell depreciable property to certain related persons, you cannot report the sale using the installment method. Instead, all payments to be received are considered received in the year of sale. Depreciable property for this rule is any property that the purchaser can depreciate.

Payments to be received include the total of all noncontingent payments and the FMV of any payment contingent as to amount.

In the case of contingent payments for which the FMV cannot be reasonably determined, the basis is recovered ratably. The purchaser cannot increase the basis of any property acquired in the sale by any amount before the seller includes the amount in income.

Exceptions to Rule 1. Rule 1 will not apply if no significant tax deferral benefit will be derived from the sale. It does not apply if you can show to the satisfaction of IRS that avoidance of federal income tax was not one of the principal purposes of the sale.

Rule 2—Sale and Resale

Generally, a special rule applies if you (an installment seller) make a first disposition (sale or exchange) to a related person who then makes a second disposition (sale, exchange, or gift) under the following circumstances.

- 1) The related person makes the second disposition before making all payments on the first disposition.
- 2) The related person makes the second disposition within 2 years of the first disposition.

Under this rule, you treat part or all of the amount the related person realizes (or the FMV if the disposed property is not sold or exchanged) from the second disposition as if you received it from the first disposition at the time of the second disposition.

Example 1. In 1997, Harvey Green sold farm land to his son Bob for \$500,000, which was to be paid in five equal payments over 5 years, plus adequate stated interest on the balance due. His installment sale basis for the farm land was \$250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (gross profit of \$250,000 ÷ contract price of \$500,000). He received \$100,000 in 1997 and included \$50,000 in income for that year (\$100,000 × 0.50). Bob made no improvements to the property and sold it to Alfalfa Inc. in 1998 for \$600,000 after making the payment for that year. The amount realized from the second disposition is \$600,000. Harvey figures his installment sale income for 1998 as follows:

Lesser of: 1) Amount realized on second disposition, or 2) Contract price on first disposition	\$500,000
Subtract: Sum of payments from Bob in 1997 and 1998	= 200,000
Amount treated as payment because of second disposition	\$300,000
Add: Payment from Bob in 1998	+ 100,000
Total payments received and treated as received for 1998	\$400,000
Multiply by gross profit %	× .50
Installment sale income for 1998	\$200,000

Harvey will not include in his installment sale income any principal payments he receives on the installment obligation for 1999, 2000, and 2001 because he has already reported the total payments of \$500,000 from the first disposition (\$100,000 in 1997 and \$400,000 in 1998).

Example 2. Assume the facts are the same as *Example 1* except that Bob sells the property for only \$400,000. The gain for 1998 is figured as follows:

Lesser of: 1) Amount realized on second disposition, or 2) Contract price on first disposition	\$400,000
Subtract: Sum of payments from Bob in 1997 and 1998	- 200,000
Amount treated as payment because of second disposition	\$200,000
Add: Payment from Bob in 1998	+ 100,000
Total payments received and treated as received for 1998	\$300,000
Multiply by gross profit %	x .50
Installment sale income for 1998	<u>\$150,000</u>

Harvey receives a \$100,000 payment in 1999 and another in 2000. They are not taxed because he treated the \$200,000 from the disposition in 1998 as a payment received and paid tax on the gain. In 2001, he receives the final \$100,000 payment. He figures the gain he must recognize in 2001 as follows:

Total payments from the first disposition received by the end of 2001	\$500,000
Minus the sum of:	
Payment from 1997	\$100,000
Payment from 1998	100,000
Amount treated as payment in 1998	200,000
Total on which gain was previously recognized	- 400,000
Payment on which gain is recognized for 2001	\$100,000
Multiply by gross profit %	x .50
Installment sale income for 2001	<u>\$50,000</u>

Exceptions to Rule 2. These rules do not apply to a second disposition, and any later transfer, if you can show, to the satisfaction of the IRS, that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, an involuntary second disposition will qualify under the nontax avoidance exception, such as when a creditor of the related person forecloses on the property or the related person declares bankruptcy.

The nontax avoidance exception also applies to a second disposition that is also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception does not apply if the resale terms permit significant deferral of recognition of gain from the first sale as, for example, if amounts from the resale are collected sooner.

In addition, any sale or exchange of stock to the issuing corporation is not treated as a first disposition. An involuntary conversion is not treated as a second disposition if the first disposition occurred before the threat of conversion. A transfer after the death of the person making the first disposition or the related person's death, whichever is earlier, is not treated as a second disposition.

Like-Kind Exchange

If you trade business or investment property for the same kind of property, you can postpone reporting part of the gain. 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 give up.

In a like-kind exchange, you do not have to report any part of your gain if you receive only like-kind property. However, if you also receive money or other property 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 Publication 544.

Installment payments. If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply.

- 1) The contract price is reduced by the FMV of the like-kind property received in the trade.
- 2) The gross profit is reduced by any gain on the trade that can be postponed.
- 3) Like-kind property received in the trade is not considered payment on the installment obligation.

Example. In 1998, George Brown trades personal property with an installment sale basis of \$400,000 for like-kind property having an FMV of \$200,000. He also receives an installment note for \$800,000 in the trade. Under the terms of the note, he is to receive \$100,000 (plus interest) in 1999 and the balance of \$700,000 (plus interest) in 2000.

George's selling price is \$1,000,000 (\$800,000 installment note + \$200,000 FMV of like-kind property received). His 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). He reports no gain in 1998 because the like-kind property he receives is not treated as a payment for figuring gain. He reports \$75,000 gain for 1999 (75% of \$100,000 payment received) and \$525,000 gain for 2000 (75% of \$700,000 payment received).

Deferred exchanges. A deferred exchange is one in which you have transferred the property and are to receive like-kind property at a later date. 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 will not 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.

Contingent Payment Sale

For installment sales, a contingent payment sale is one whose total selling price cannot be determined by the end of the tax year in which the sale takes place.

If the selling price cannot be determined by the end of the tax year, the contract price and the gross profit percentage cannot be determined (using the same rules that apply to an installment sale with a fixed selling price). This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years.

For rules on using the installment method for a contingent payment sale or a contingent payment sale with unstated interest, 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*, next.

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 by the debt. This is 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 cannot 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 did not 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.

Since the installment sale basis for parcel C was more than its FMV, 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 the proportionate net FMV. The allocation is figured as follows:

	Parcels A and B	Parcel C
FMV	\$120,000	\$10,000
Minus: Mortgage assumed ..	30,000	-0-
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%	\$18,000	
\$20,000 × 10%		\$2,000
Excess of parcel B mortgage over installment sale basis ..	15,000	
Allocation of payments re- ceived (or considered re- ceived) in year of sale	<u>\$33,000</u>	<u>\$2,000</u>

You cannot 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 is not 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 is not the sale of a single asset.

Allocation of selling price. The selling price must be allocated for each asset class for the following reasons.

- 1) The sale of a business generally includes real and personal property that can be reported on the installment method and inventory items that cannot.
- 2) Any depreciation recapture income from the sale of depreciable property cannot be reported on the installment method. It is reported in full in the year of the sale.
- 3) Assets sold at a loss cannot be reported on the installment method.

Inventory. 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 do not, each payment must be allocated between the inventory and the other assets sold.

The sale of inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if you are paid in later years.

Report the amount you receive (or will receive) on the sale of inventory items as ordinary business income. Use your basis in the items to figure the cost of goods sold and 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 transferred. This method determines gain or loss from the transfer of each asset.

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. A group of assets constitutes a trade or business if goodwill or going concern value could, under any circumstances, attach to the assets.

The residual method provides for the sale price to first be reduced by cash, demand deposits, and similar accounts transferred by the seller. The sale price remaining after this reduction must be allocated among the various business assets in a specified order.

The allocation must be made among the following assets in proportion to (but not in excess of) their FMV on the purchase date in the following order.

- 1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
- 2) All other assets except section 197 intangibles.
- 3) Section 197 intangibles, except intangible assets in the nature of goodwill and going concern value.

- 4) Section 197 intangibles in the nature of goodwill and going concern value.

More information. For more information, see *Sale of a Business* in chapter 2 of Publication 544. For more information on section 197 intangibles, see chapter 12 of Publication 535.

How to report the sale of a business. Both the seller and buyer must prepare and attach **Form 8594, Asset Acquisition Statement Under Section 1060**, to their income tax return for the year the sale occurred. If the amount allocated to any asset is increased or decreased after Form 8594 is filed, a supplemental statement in Part III of a new Form 8594 must be completed.

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. However, the partner must allocate a portion of the proceeds to ordinary income if the partnership's assets included unrealized receivables and inventory items. (The term "unrealized receivables" includes depreciation recapture income, discussed earlier.)

The gain allocated to the unrealized receivables and the inventory cannot 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 Publication 541.

Example

On January 4, 1998, you sold the machine shop you operated since 1988. 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 1999. 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:

Asset	FMV	Depreciation	
		Claimed	Adjusted Basis
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	6,500	18,624	5,376
	<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 amount is allocated to your section 197 intangible, goodwill (\$18,500).

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.

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

The building was acquired in 1988, the year the business began, and it is section 1250 property. There is 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 is 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 since it was less than the depreciation claimed). These gains are reported in full in the year of sale and are not included in the installment sale computation.

Of the \$220,000 total selling price, the \$10,000 for inventory assets cannot be reported on 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 basis are shown in the following chart.

	Selling Price	Installment Sale Basis	Gross Profit
Land	\$42,000	\$17,100	\$24,900
Building	48,000	38,400	9,600
Goodwill	18,500	925	17,575
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 ÷ \$108,500). The gross profit percentage for each asset is figured as follows:

	Percentage
Land—\$24,900 ÷ \$108,500	22.95
Building—\$9,600 ÷ \$108,500	8.85
Goodwill—\$17,575 ÷ \$108,500	16.20
Total	<u>48.00</u>

Since the sale includes assets sold on the installment method and assets for which the gain is reported in full in the year of sale, 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 ÷ \$220,000). The selling price of assets not reported on the installment method is \$111,500. This is 50.7% (\$111,500 ÷ \$220,000) of the total selling price.

Multiply principal payments by 49.3% 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 in-

installment sale (49.3%) is used in the installment sale computation.

The only payment received in 1998 is the down payment of \$100,000. The part of the payment for the installment sale is \$49,300 (\$100,000 × 49.3%). This amount is used in the installment sale computation.

Installment income for 1998. Your installment income for each asset is the gross profit percentage for that asset times \$49,300, the installment income received in 1998.

	<u>Income</u>
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 1998	<u>\$23,664</u>

Installment income after 1998. You figure installment income for years after 1998 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

An installment sale contract generally provides 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 with some or all payments due more than one year after the date of sale does not provide for interest, part of each payment due more than 6 months after the date of sale may be treated as interest. The amount treated as interest is called **unstated interest**.

When the stated interest rate in the contract is lower than the applicable federal rate (AFR), defined below, unstated interest is the difference between interest figured at the federal rate and any interest figured at the rate specified in the sales contract.

Generally, the unstated interest rules do not apply to a debt given in consideration for a sale or exchange of personal-use property. Personal-use property is any property in which substantially all of its use by the buyer is not in connection with a trade or business or an investment activity.

Applicable federal rate (AFR). The AFR depends on the month the binding contract for the sale or exchange of property is made 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 applicable federal rates are published monthly in the Internal Revenue Bulletin. You can get this information by contacting an IRS office.

Effects of Unstated Interest

If the unstated interest rules apply, you and the buyer must treat part of the installment sale price as interest. The unstated interest rules require you to treat part of each payment as interest, even though it is not called interest in your agreement with the buyer. Unstated interest reduces the stated selling price of the property and increases your interest income. It also reduces the buyer's basis in the property and increases the buyer's interest expense.

If you do not use the installment method to report the sale, you report the entire gain in the year of sale. You must reduce the selling price by the total unstated interest before you can determine the gain.

You must report the unstated interest plus any interest specified under the contract on your tax return.

Figuring Unstated Interest

A debt instrument must provide for adequate stated interest. If not, unstated interest is figured on the debt. Generally, a debt instrument provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest applicable to the debt instrument.

Test rate of interest. The test rate of interest for a debt instrument is the 3-month rate. The 3-month rate is the lower of either of the following AFRs.

- 1) The lowest AFR in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated.
- 2) The lowest AFR in effect during the 3-month period ending with the month in which the sale or exchange occurs.

Special rules. For sales or exchanges of property (other than new section 38 property, which includes most tangible personal property) involving seller financing of \$3,823,100 or less, the test rate of interest cannot be more than 9%, compounded semiannually. For seller financing over \$3,823,100, and for all sales or exchanges of new section 38 property, the test rate of interest is 100% of the AFR.

For information on new section 38 property, see section 48(b) of the Internal Revenue Code, as in effect before the enactment of Public Law 101-508.

Relationship of Internal Revenue Code sections 1274 and 483. Unstated interest is imposed under section 1274 or 483 of the Code, depending on the characteristics (amount, kind of property, etc.) of the debt instrument and the sale or exchange for which it is given in consideration.

Section 1274 applies to any debt instrument issued for the sale or exchange of property if some or all payments due under the debt instrument are due more than 6 months after the date of sale or exchange. The AFR is determined under section 1274 and interest determined under that section is treated as original issue discount.

Section 483 applies to sales or exchanges of property not covered by the provisions of section 1274. Interest determined under section 483 is treated as unstated interest.

Section 483 rules. The section 483 rules apply to payments on the sale or exchange of property under a contract in which the following conditions exist.

- 1) Some or all payments are due more than one year after the date of sale or exchange.
- 2) There is total unstated interest (or inadequate stated interest).

Unstated interest is figured on any payment that meets the following conditions.

- 1) The payment constitutes all or part of the selling price.
- 2) The payment is due more than 6 months after the date of sale or exchange.

Total unstated interest. Total unstated interest is the amount equal to the excess of item 1 over item 2, listed next.

- 1) The sum of payments due under the contract.
- 2) The sum of the present values of the payments and the present values of any interest payments due under the contract.

Transactions to which section 483 rules apply. The section 483 rules apply to the following items.

- 1) Debt instruments from the transactions listed below.
 - a) The sale or exchange of a farm for \$1,000,000 or less by the following persons.
 - i) An individual.
 - ii) An estate.
 - iii) A testamentary trust.
 - iv) A small business corporation (defined in section 1244(c)(3) of the Internal Revenue Code).
 - v) A domestic partnership that meets requirements similar to those of section 1244(c)(3).
 - b) The sale or exchange of a main home by the owner.
 - c) The sale or exchange of property with total payments (principal and interest) of \$250,000 or less.
 - d) Certain land transfers between related persons.
- 2) A cash method debt instrument.

Sale of a farm. The section 483 rules apply to the sale of a farm if the selling price cannot exceed \$1,000,000. If the selling price can exceed \$1,000,000, the section 1274 rules (discussed later) apply. For determining the selling price, all sales and exchanges that are part of the same transaction (or a series of transactions) are treated as one sale or exchange.

Sale with total payments of \$250,000 or less. The section 483 rules apply if the sum of the following amounts does not exceed \$250,000.

- 1) The total payments (interest and principal) due under the debt instrument and under all other debt instruments received as consideration for the sale or exchange.

- 2) The total of any other consideration to be received for the sale or exchange.

The section 1274 rules apply if the amount exceeds \$250,000.

Any consideration (other than a debt instrument) is taken into account at its FMV. All sales and exchanges that are part of the same transaction (or series of related transactions) are treated as one sale or exchange.

Land sale between related persons.

The section 483 rules apply to debt instruments issued in a land sale between related persons to the extent the sum of the following amounts does not 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 is in excess of \$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, brother and sister (whether by whole or half blood), ancestors, and lineal descendants.

Cash method debt instrument. This is any debt instrument given as consideration for the sale or exchange of property (other than new section 38 property) with a stated principal of \$2,730,800 or less if the following items apply.

- 1) The lender (holder) does not use an accrual method of accounting and is not a dealer in the type of property sold or exchanged.
- 2) Both the borrower (issuer) and the lender jointly elect to account for interest on the debt instrument under the cash method of accounting.
- 3) Section 1274 of the Internal Revenue Code would apply except for the election in (2) above.

Exceptions to section 483 rules. The unstated interest rules do not apply to the following types of transactions.

Sale price of \$3,000 or less. If it can be determined at the time of sale or exchange of the property that the selling price will not exceed \$3,000, the unstated interest rules do not apply to the sale or exchange.

Carrying charges. The buyer of personal property does not figure unstated interest if any part of the payment includes separately stated carrying charges.

Additional exceptions. See the discussion of the exceptions that apply to both sections 483 and 1274, later.

Section 1274 rules. The section 1274 rules apply to any debt instrument given in consideration for the sale or exchange of property under the following conditions in both 1) and 2).

- 1) The stated redemption price at maturity for the debt instrument exceeds the amount in either a) or b), below.

- a) The stated principal when there is adequate stated interest.
 - b) The imputed principal in all other cases.
- 2) Some or all payments under the debt instrument are due more than 6 months after the date of the sale or exchange.

Imputed principal. There is adequate stated interest under section 1274 if the stated principal for a debt instrument is less than or equal to the imputed principal. The imputed principal of any debt instrument is equal to the sum of the present values of all payments under the debt instrument. The present value of any payment is determined by using the AFR for the date of sale or exchange. If a debt instrument has a single fixed interest rate paid or compounded at least annually, and the rate is equal to or greater than the test rate, there is adequate stated interest.

Issue price. In transactions to which section 1274 applies, the issue price of the debt instrument must be determined. Where there is adequate stated interest, the issue price is the stated principal. If the debt instrument does not provide for adequate stated interest, the issue price of the instrument is the imputed principal of the debt instrument. The issue price of a debt instrument is generally used to determine the sale price (in whole or in part) of any property acquired for the debt instrument.

Exceptions to imputed principal rules. The imputed principal rules do not apply to any of the debt instruments involved in transactions listed earlier under *Transactions to which section 483 rules apply*. (Also see *Exceptions to sections 483 and 1274*, below.)

Assumption of debt instrument. Do not apply the imputed principal rules to the assumption of a debt instrument or if property is taken subject to the debt instrument. However, these rules do apply if the terms or conditions of the debt instrument are modified or the nature of the transaction is changed.

Exceptions to sections 483 and 1274. The unstated interest and imputed principal rules do not apply in the following circumstances.

Publicly traded debt instruments or property. Transactions involving publicly traded debt instruments or any debt instrument issued in consideration for the sale or exchange of publicly traded property are not subject to these rules. A publicly traded instrument is one that is traded on an established securities market.

Patents. When all substantial rights to a patent, or an undivided interest in property that includes part of all substantial rights to a patent, are sold or exchanged, do not figure unstated interest or imputed principal on any amount contingent on the productivity, use, or disposition of the property transferred. This rule applies only if long-term capital gain or loss treatment applies to the sale (see Publication 544).

Annuities. Payments that depend in whole or in part on the life expectancy of any individual do not require the computation of unstated interest or imputed principal.

Personal-use property. Debt instruments issued in consideration for the sale or exchange of personal-use property where substantially all of its use by the buyer is for other than a trade or business or as income-producing property are not subject to the unstated interest or imputed principal rules.

More information. For information on figuring unstated interest and other special rules, see sections 483 and 1274 of the Internal Revenue Code and their regulations.

Disposition of 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 the buyer will make future payments to you.

If you are using the installment method and you dispose of the installment obligation, you generally have a gain or loss to report. It is 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.

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

- 1) If you **sell or exchange the obligation**, or if you accept less than face value in satisfaction of the obligation, the gain or loss is the difference between your basis in the obligation and the amount you realize.
- 2) If you **dispose of the obligation in any other way**, the 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. Because your gross profit percentage is 60%, \$6,000 (60% × \$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 a husband and wife or a former husband and wife if incident to a divorce. A transfer is incident to a divorce if it occurs within one 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 does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

Gift. A gift of an installment obligation is a disposition. The 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 *Transfers between spouses or former spouses*, above.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is 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. The gain or loss is the difference between your basis in the obligation and the amount you realize on the settlement.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not 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* under *General Rules*, 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 have not disposed of the installment obligation. It is not 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 (or other holder of the obligation) is not a disposition. Any unreported gain from the installment obligation is not treated as gross income to the decedent. No income is reported on the decedent's return due to the transfer. This means 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 if the seller had 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 is 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.

- 1) Your gain (or loss) on the repossession.
- 2) 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.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. It does not matter how you repossess the property, whether you foreclose or the buyer voluntarily surrenders the property to you. However, it is not 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 Form 4797 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, it is added 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.

For sales not reported on the installment method: (see *Electing Out of Installment Method*, earlier.)

Basis in installment obligation. Your basis is figured on its full face value or its FMV at the time of the original sale, whichever you used to figure your gain or loss in the year of sale. From this amount, subtract all payments of principal you have received on the obligation. The result is your basis in the installment obligation. If only part of the obligation is discharged by the repossession, figure your basis in only that part.

Gain or loss. To your basis in the obligation, add any repossession costs. If the FMV of the property you repossess is more than this total, you have a gain. Because it is gain on the installment obligation, it is 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. Because you included the full gain in income in the year of sale, 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 Publication 550 for information on nonbusiness bad debts and chapter 14 of Publication 535 for information on business bad debts.

For sales reported on the installment method:

Basis in installment obligation. Multiply the unpaid balance of your installment obli-

gation 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 the same character (capital or ordinary) as your gain on the original sale.



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

1) FMV of property repossessed	_____
2) Unpaid balance of installment obligation	_____
3) Unrealized profit (line 2 × gross profit %)	_____
4) Basis of obligation (line 2 – line 3)	_____
5) Plus: Repossession costs	_____
6) Gain or loss on repossession (line 1 – line 5)	=====

Example. You sold your piano for \$1,500 in December 1997 for \$300 down and \$100 a month (plus interest). The payments began in January 1998. Your gross profit percentage is 40%. You reported the sale on the installment method on your 1997 income tax return. After the fourth monthly payment, the buyer defaults on the contract (which has an unpaid balance of \$800) and you are forced to foreclose on 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 follows:

1) FMV of property repossessed	\$1,400
2) Unpaid balance of installment obligation	\$800
3) Unrealized profit (line 2 × gross profit %)	320
4) Basis of obligation (line 2 – line 3)	480
5) Plus: Repossession costs	75
6) Gain on repossession (line 1 – line 5)	<u>\$845</u>

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

Fair market value (FMV). 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 is 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 as 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.

Therefore, you must regard as income to you the total payments you have received from the buyer on the original sale. You re-

port, as gain on the repossession, any part of the payments you have not 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, as discussed later.

Conditions. The following rules 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 cannot pay any additional consideration to the buyer to get your property back, unless either of the situations listed below apply.
 - a) The reacquisition 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 is not met, use the rules discussed under *Personal Property*, earlier, as if the property you repossess were personal rather than real property. Do not use the rules for real property.

Figuring gain on repossession. Your gain on repossession is the difference between the following amounts.

- 1) The total payments received, or considered received, on the sale.
- 2) The total gain already reported as income.

See the earlier discussions under *Payments Received* for items considered payment on the sale.

Limit on taxable gain. Taxable gain is limited to your gross profit on the original sale minus the sum of the following amounts.

- 1) The gain on the sale you reported as income before the repossession.
- 2) Your repossession costs.

This method of figuring taxable gain, in essence, treats all payments received on the sale as income, but limits your total taxable gain to the gross profit you originally expected on the sale.

Indefinite selling price. The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price stated as a percentage of the profits to be realized from a buyer's development of the property is an indefinite selling price.

Character of gain. The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original

sale. However, if you did not report the sale on the installment method, the gain is ordinary income.

Repossession costs. Your repossession costs include money or property you pay to reacquire the real property. This includes amounts paid to the buyer of the property, as well as amounts paid to others for such items as those listed below.

- 1) Court costs.
- 2) Legal fees.
- 3) Publishing, acquiring, filing, or recording of title.
- 4) Lien clearance.

Repossession costs do not include the FMV of the buyer's obligations to you that are secured by the real property.



Use the following worksheet to determine the taxable gain on a repossession of real property reported on the installment method.

1) Payments received before repossession ..	_____
2) Minus: Gain reported	_____
3) Gain on repossession	_____
4) Gross profit on sale	_____
5) Gain reported (line 2)	_____
6) Plus: Repossession costs	_____
7) Subtract line 6 from line 4	_____
8) Taxable gain (lesser of line 3 or 7)	_____

Example. You sold a tract of land in January 1996 for \$25,000. You accepted from the buyer a \$5,000 down payment, plus a \$20,000 mortgage secured by the property and payable at the rate of \$4,000 annually plus interest (9.5%). The payments began on January 1, 1997. Your adjusted basis in the property was \$19,000 and you reported the transaction as an installment sale. Your selling expenses were \$1,000. You figured your gross profit as follows:

Selling price	\$25,000
Minus:	
Adjusted basis	\$19,000
Selling expenses	<u>1,000</u> 20,000
Gross profit	<u>\$5,000</u>

For this sale, the contract price equals the selling price. The gross profit percentage is 20% (\$5,000 gross profit ÷ \$25,000 contract price).

In 1996, you included \$1,000 in income (20% × \$5,000 down payment). In 1997, you reported a profit of \$800 (20% × \$4,000 annual installment). In 1998, the buyer defaulted and you repossessed the property. You paid \$500 in legal fees to get your property back. Your taxable gain on the repossession is figured as follows:

1) Payments received before repossession ..	\$9,000
2) Minus: Gain reported	<u>1,800</u>
3) Gain on repossession	<u>\$7,200</u>
4) Gross profit on sale	\$5,000
5) Gain reported (line 2)	\$1,800
6) Plus: Repossession costs	<u>500</u> 2,300
7) Subtract line 6 from line 4	<u>\$2,700</u>
8) Taxable gain (lesser of line 3 or 7)	<u>\$2,700</u>

Basis. Your basis in the repossessed property is determined as of the date of repossession. It is the sum of the following amounts.

- 1) Your adjusted basis in the installment obligation.
- 2) Your repossession costs.

- 3) Your taxable gain on the repossession.

To figure your adjusted basis in the installment obligation at the time of repossession, multiply the unpaid balance by the gross profit percentage. Subtract that amount from the unpaid balance.



Use the following worksheet to determine the basis of real property repossessed.

1) Unpaid balance of obligation	_____
2) Minus: Unrealized profit (line 1 × gross profit %)	_____
3) Adjusted basis (date of repossession)	_____
4) Plus: Taxable gain on repossession	_____
Repossession costs	_____
5) Basis of repossessed real property	_____

Example. Assume the same facts as the preceding example. The unpaid balance of the installment obligation (the \$20,000 note) is \$16,000 at the time of repossession because the buyer made a \$4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, \$3,200 (20% × \$16,000 still due on the note) is unrealized profit. You figure your basis in the repossessed property as follows:

Unpaid balance of obligation	\$16,000
Minus: Unrealized profit	<u>3,200</u>
Adjusted basis (date of repossession)	\$12,800
Plus: Taxable gain on repossession	\$2,700
Repossession costs	<u>500</u> 3,200
Basis of repossessed real property	<u>\$16,000</u>

Holding period for resales. If you resell the repossessed property, the resale may result in a capital gain or loss. To figure whether the gain or loss is long-term or short-term, your holding period includes the period you owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.

If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad debt. If you repossess real property under these rules, you cannot take a bad debt deduction for any part of the buyer's installment obligation. This is true even if the obligation is not fully satisfied by the repossession.

If you took a bad debt deduction before the tax year of repossession, you are considered to have recovered the bad debt when you repossess the property. You must report the bad debt deduction you took in the earlier year as income in the year of repossession. However, if any part of the earlier deduction did not reduce your tax, you do not have to report that part as income. Your adjusted basis in the installment obligation is increased by the amount you report as income from recovering the bad debt.

Reporting an Installment Sale

Form 6252. Use Form 6252 to report a sale of property on the installment method. The form is used to report the sale in the year it

takes place and to report payments received in later years. Also, if you sold property to a related person, you may have to file the form each year until the installment debt is paid off, whether or not you receive a payment in that year.

Related person. If you sell marketable securities to a related person, complete Part III, Form 6252, for each year of the installment agreement, even if you do not receive a payment in that year.

If you sell property other than marketable securities to a related person, complete Part III for the year of sale and the 2 years following the year of sale, even if you do not receive a payment. After this 2-year period, you do not have to fill out Part III.

If the related person to whom you sold your property disposes of it, you may have to immediately report the rest of your gain in Part III. See *Rule 2—Sale and Resale* under *Sale to Related Person*, earlier, for more information.

Several assets. If you sell two or more assets in one installment sale, you may have to separately report the sale of each asset. The same is true if you sell all the assets of your business in one installment sale. See *Single Sale of Several Assets* and *Sale of a Business*, earlier.

If you have only a few sales to separately report, you can use a separate Form 6252 for each one. However, if you have to separately report the sales of many assets that you sold together, do not prepare a separate Form 6252 for each one. Instead, prepare one Form 6252 and attach a schedule with all the information for each asset that is required by Form 6252. Complete Form 6252 by following the steps listed below.

- 1) Answer the questions at the top of the form.
- 2) In the year of sale, do not complete Part I. Instead, write "See attached schedule" in the margin.
- 3) For Part II, enter the total for all the assets on lines 24, 25, and 26.
- 4) For Part III, answer all the questions that apply. If none of the exceptions under question 29 apply, enter the totals on lines 35, 36, and 37 for the disposed assets.

Special situations. If you are reporting payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, you may not be able to provide all the information asked for on Form 6252. To the extent possible, follow the instructions given above and provide as many details as possible in a statement attached to Form 6252.

For more information on how to complete Form 6252, see the form instructions.

Other forms. The gain from Form 6252 is carried over and entered on Schedule D (Form 1040), *Capital Gains and Losses*, Form 4797, *Sales of Business Property*, or both.

Schedule D (Form 1040). Enter the gain figured on Form 6252 for personal-use property (capital assets) on Schedule D (Form 1040). If your gain from the installment sale qualifies for long-term capital gain treatment in the year of sale, it will continue to qualify in later tax years. Your gain is long-term if you owned the property for more than one year when you sold it.

Although the references in this publication are to the Schedule D for Form 1040, the rules discussed also apply to Schedule D for Forms 1041 (estates and trusts), 1065 (partnerships), 1120 or 1120-A (corporations), or 1120S (S corporations).

Form 4797. An installment sale of property used in your business or property that earns rent or royalty income may result in a capital gain, an ordinary gain, or both. All or part of any gain from its disposition may be ordinary gain from depreciation recapture. Use Form 4797 to report these transactions and to determine the ordinary or capital gain or loss.

Form 4797 is used with estate and trust, partnership, corporation, and S corporation returns, as well as individual returns.

Payments past due. If you use the cash method of accounting, do not report payments of principal you have not yet received, even if they are past due. However, if you use an accrual method of accounting, you accrue any payment due, even if you have not received it.

Examples

The following examples illustrate how to fill out Form 6252. Sample filled-in forms follow.

Example 1

On November 1, 1998, Mark Moore sold a lot that he bought on February 17, 1991, for \$2,650. He borrowed more on the lot than he had paid for it. At the time of the sale, \$6,500 remained outstanding on these loans. In the sales contract, the buyer agreed to assume these loans and pay Mark \$200 a month (plus 7% interest) for 3 years. In addition, the buyer made a down payment of \$1,000 on the sale.

Mark fills out his 1998 Form 6252 as follows:

Question 1. Mark writes in a description of the lot he sold.

Questions 2a and 2b. Mark enters the date he acquired the lot and the date he sold it.

Question 3. Because Mark sold the lot to Acme Design, a partnership of which he is a member, he checks the "Yes" box.

Question 4. The property Mark sold was not a marketable security (such as stock or a bond). He answers "No" to this question. Because he sold the lot to a related person, he must complete Part III for 1998 and the next 2 years.

Part I. Mark uses this part of the form to figure the contract price and his gross profit on the sale.

Line 5. Mark enters the selling price, \$14,700. This includes the \$1,000 down payment, the \$7,200 (36 × \$200) in monthly payments he is to receive, and the \$6,500 in loans the buyer assumes.

Line 6. Mark enters the \$6,500 in outstanding loans that the buyer assumes.

Line 7. Mark subtracts line 6 from line 5 and enters the difference, \$8,200.

Line 8. Because he did not make any improvements to the lot, Mark's basis at the time of the sale was the lot's cost of \$2,650.

Lines 9 and 10. Mark did not take depreciation deductions on the lot (land is never depreciable). The amount on line 8 carries over to line 10.

Line 11. Mark's only selling expenses were \$150 in legal fees. If he had advertised the lot for sale or paid commission on the sale, he would have included those amounts also.

Line 12. Since no depreciation was claimed on the land, Mark has no recapture of income.

Line 13. Mark's installment sale basis is \$2,800, the total of his adjusted basis in the property plus his selling expenses.

Line 14. Mark subtracts line 13 from line 5 and enters the result, \$11,900.

Lines 15 and 16. The property Mark sold was not his home. He carries the amount on line 14 to line 16. This is his gross profit on the sale.

Line 17. Mark subtracts line 13, \$2,800, from line 6, \$6,500. The result, \$3,700, is the amount by which the assumed loans are more than his installment sale basis in the property. This amount is treated as a payment in the year of sale on line 20.

Line 18. The contract price is the sum of all payments Mark will receive on the sale. This includes the down payment and all installment payments he will receive (line 7). It also includes the "payment" figured on line 17.

Part II. In this part, Mark figures the gain from the sale he must report for 1998.

Line 19. Mark's gross profit percentage for the sale is 100%. This is the gross profit on line 16, \$11,900, divided by the contract price on line 18, also \$11,900.

Line 20. Mark carries the amount he treats as a payment on line 17 to this line and it is added to the other payments he received in the year of sale.

Line 21. At the time of the sale, Mark received a down payment of \$1,000. In December 1998, he received his first monthly installment payment. The total payment was \$242, consisting of \$42 interest (one month's interest on \$7,200 figured at 7% a year) and \$200 principal. This is the only installment payment he received in 1998. He enters the total received during 1998, \$1,200 (\$1,000 + \$200), on this line. He reports the \$42 interest on Form 1040.

Line 22. Mark enters \$4,900, the sum of line 20 plus line 21. This is the total of all payments he is considered to have received in 1998.

Line 23. Since 1998 is the year of sale, Mark makes no entry here.

Line 24. The gross profit percentage (line 19) is 100%. Therefore, the entire amount on line 22, \$4,900, is taxable gain. Mark enters this amount on line 24.

Lines 25 and 26. Because the lot Mark sold was not depreciable property, he does not have to recapture any depreciation deductions as ordinary gain. All his gain on the sale is long-term capital gain. He carries the amount on line 26 to Schedule D (Form 1040) where it is included with other long-term capital gains.

Part III. Because Mark sold the lot to his partnership, a "related person," he must fill out this part. The property he sold was not a marketable security and he completes this part for 1998, 1999, and 2000.

Line 27. Mark enters the name, address, and employer identification number of the partnership that bought the lot.

Line 28. The partnership did not sell the lot in 1998. Mark checks the "No" box and he does not have to fill out the rest of Part III.

Example 2

In December 1997, Cora Blue sold a painting she inherited. The buyer paid her \$700 down and gave her an installment note for \$3,800. The note calls for quarterly payments of \$530 until the \$3,800 debt is paid off, in about 2 years. Each \$530 payment includes interest figured at 10% a year on the outstanding debt. She received her first 4 payments on the note in 1998. The principal and interest she received in each payment is given in the table below:

Payment	Interest	Principal
First	\$95.00	\$435.00
Second	84.13	445.87
Third	72.98	457.02
Fourth	61.55	468.45
	<u>\$313.66</u>	<u>\$1,806.34</u>

Cora rounds off cents on her tax return. She reports \$314 interest as ordinary income on Form 1040. She completes Form 6252 as follows:

Question 1. Cora states the property she sold was an oil painting.

Questions 2a and 2b. She enters the date she acquired the painting and the date she sold it.

Question 3. The buyer was not related to Cora. She checks the "No" box.

Question 4. Because she checked "No" to question 3, Cora does not have to answer this question or fill out Part III of the form.

Part I. Cora completed Part I of her Form 6252 for the year of sale, 1997. She does not fill it out for the remaining years of the installment sale.

Part II. This is the only part of Form 6252 that Cora fills out.

Line 19. Cora figured a gross profit percentage of 22.7% on her 1997 Form 6252. She uses the same percentage on her 1998 Form 6252.

Line 20. Since this is not the year of sale, Cora enters zero on this line.

Line 21. Cora enters the total amount (minus interest) that she received on the sale in 1998, \$1,806.

Line 22. The amount on line 21 carries over to line 22.

Line 23. Before 1998, Cora received only the \$700 down payment.

Line 24. Cora multiplies the gross profit percentage of 22.7% (line 19), by the amount she was paid in 1998 (line 22), \$1,806. The result, \$410, is the gain she had on the sale in 1998.

Lines 25 and 26. Cora did not use the painting in a business. It was not depreciable and the recapture rules do not apply. The amount on line 24 carries over to line 26. Her gain is long-term capital gain. She carries the amount on line 26 to Schedule D (Form 1040), where it is included with other long-term capital gains.

Installment Sale Income

Department of the Treasury Internal Revenue Service

See separate instructions. Attach to your tax return. Use a separate form for each sale or other disposition of property on the installment method.

1998

Attachment Sequence No. 79

Name(s) shown on return

Mark Moore

Identifying number

222-00-3333

- 1 Description of property Undeveloped land
2a Date acquired (month, day, year) 2 / 17 / 91
b Date sold (month, day, year) 11 / 1 / 98
3 Was the property sold to a related party after May 14, 1980? See instructions. If "No," skip line 4. Yes No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale. Yes No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

Table with 18 rows for Part I calculations. Line 5: Selling price including mortgages and other debts. 14,700. Line 6: Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source. 6,500. Line 7: Subtract line 6 from line 5. 8,200. Line 8: Cost or other basis of property sold. 2,650. Line 9: Depreciation allowed or allowable. -0-. Line 10: Adjusted basis. Subtract line 9 from line 8. 2,650. Line 11: Commissions and other expenses of sale. 150. Line 12: Income recapture from Form 4797, Part III. See instructions. -0-. Line 13: Add lines 10, 11, and 12. 2,800. Line 14: Subtract line 13 from line 5. If zero or less, stop here. Do not complete the rest of this form. 11,900. Line 15: If the property described on line 1 above was your main home, enter the amount of your excluded gain. Otherwise, enter -0-. See instructions. -0-. Line 16: Gross profit. Subtract line 15 from line 14. 11,900. Line 17: Subtract line 13 from line 6. If zero or less, enter -0-. 3,700. Line 18: Contract price. Add line 7 and line 17. 11,900.

Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

Table with 6 rows for Part II calculations. Line 19: Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions. 100%. Line 20: For year of sale only: Enter amount from line 17 above; otherwise, enter -0-. 3,700. Line 21: Payments received during year. See instructions. Do not include interest whether stated or unstated. 1,200. Line 22: Add lines 20 and 21. 4,900. Line 23: Payments received in prior years. See instructions. Do not include interest whether stated or unstated. Line 24: Installment sale income. Multiply line 22 by line 19. 4,900. Line 25: Part of line 24 that is ordinary income under recapture rules. See instructions. -0-. Line 26: Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions. 4,900.

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

- 27 Name, address, and taxpayer identifying number of related party Acme Design W. Main Street Small Town, NY 12899 10-7654321
28 Did the related party, during this tax year, resell or dispose of the property ("second disposition")? Yes No
29 If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check only the box that applies.
a The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year)
b The first disposition was a sale or exchange of stock to the issuing corporation.
c The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.
d The second disposition occurred after the death of the original seller or buyer.
e It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.
30 Selling price of property sold by related party
31 Enter contract price from line 18 for year of first sale
32 Enter the smaller of line 30 or line 31
33 Total payments received by the end of your 1998 tax year. See instructions
34 Subtract line 33 from line 32. If zero or less, enter -0-
35 Multiply line 34 by the gross profit percentage on line 19 for year of first sale
36 Part of line 35 that is ordinary income under recapture rules. See instructions
37 Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions

Installment Sale Income

Department of the Treasury
Internal Revenue Service

- ▶ See separate instructions. ▶ Attach to your tax return.
- ▶ Use a separate form for each sale or other disposition of property on the installment method.

1998

Attachment
Sequence No. **79**

Name(s) shown on return

Cora Blue

Identifying number

095-00-0000

- 1 Description of property ▶ Oil painting -- Inheritance
- 2a Date acquired (month, day, year) ▶ 7 / 3 / 89 b Date sold (month, day, year) ▶ 12 / 11 / 97
- 3 Was the property sold to a related party after May 14, 1980? See instructions. If "No," skip line 4 . . . Yes No
- 4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . Yes No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5	
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	6	
7	Subtract line 6 from line 5	7	
8	Cost or other basis of property sold	8	
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III. See instructions	12	
13	Add lines 10, 11, and 12	13	
14	Subtract line 13 from line 5. If zero or less, stop here. Do not complete the rest of this form	14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. Otherwise, enter -0-. See instructions	15	
16	Gross profit. Subtract line 15 from line 14	16	
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	
18	Contract price. Add line 7 and line 17	18	

Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19	22.7%
20	For year of sale only: Enter amount from line 17 above; otherwise, enter -0-	20	-0-
21	Payments received during year. See instructions. Do not include interest whether stated or unstated	21	1,806
22	Add lines 20 and 21	22	1,806
23	Payments received in prior years. See instructions. Do not include interest whether stated or unstated	23	700
24	Installment sale income. Multiply line 22 by line 19	24	410
25	Part of line 24 that is ordinary income under recapture rules. See instructions	25	-0-
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions	26	410

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

- 27 Name, address, and taxpayer identifying number of related party
- 28 Did the related party, during this tax year, resell or dispose of the property ("second disposition")? . . . Yes No
- 29 If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check only the box that applies.
- a The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
 - b The first disposition was a sale or exchange of stock to the issuing corporation.
 - c The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.
 - d The second disposition occurred after the death of the original seller or buyer.
 - e It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.
- | | | | |
|----|--|----|--|
| 30 | Selling price of property sold by related party | 30 | |
| 31 | Enter contract price from line 18 for year of first sale | 31 | |
| 32 | Enter the smaller of line 30 or line 31 | 32 | |
| 33 | Total payments received by the end of your 1998 tax year. See instructions | 33 | |
| 34 | Subtract line 33 from line 32. If zero or less, enter -0- | 34 | |
| 35 | Multiply line 34 by the gross profit percentage on line 19 for year of first sale | 35 | |
| 36 | Part of line 35 that is ordinary income under recapture rules. See instructions | 36 | |
| 37 | Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions | 37 | |

How To Get More Information

You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

 **Personal computer.** With your personal computer and modem, you can access the IRS on the Internet at www.irs.ustreas.gov. While visiting our Web Site, you can select:

- *Frequently Asked Tax Questions* to find answers to questions you may have.
- *Fill-in Forms* to complete tax forms online.
- *Forms and Publications* to download forms and publications or search publications by topic or keyword.
- *Comments & Help* to e-mail us with comments about the site or with tax questions.
- *Digital Dispatch* and *IRS Local News Net* to receive our electronic newsletters on hot tax issues and news.

You can also reach us with your computer using any of the following.

- Telnet at iris.irs.ustreas.gov
- File Transfer Protocol at ftp.irs.ustreas.gov
- Direct dial (by modem) **703-321-8020**

 **TaxFax Service.** Using the phone attached to your fax machine, you can receive forms, instructions, and tax

information by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



Walk-in. You can pick up certain forms, instructions, and publications at many post offices, libraries, and

IRS offices. Some libraries and IRS offices have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response 7 to 15 workdays after your request is received. Find the address that applies to your part of the country.

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- **Central part of U.S.:**
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Bloomington, IL 61702-8903
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Eastern Area Distribution Center
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Richmond, VA 23261-5074



CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) for \$25.00 by calling 1-877-233-6767 or for \$18.00 on the Internet at www.irs.ustreas.gov/cdorders. The first release is available in mid-December and the final release is available in late January.

Index

A		F		L		Holding period for resale 11	
Assistance (<i>See More information</i>) 16		Fair market value 4, 10		Like-kind exchange 6		Personal property 10	Real property 10
B		Figuring installment income 2		M		Worksheets 11	
Basis:		Form:		More information 16		S	
Adjusted 2		4797 3, 5, 12		N		Sale of:	
Assumed mortgage 4		6252 3, 11, 12		Note:		Business 7	Dealer 2
Installment obligation 9, 10		8594 7		Buyer's 4		Farm 8	Home 3
Installment sale 2		Schedule D (Form 1040) . . . 3, 12		Third-party 4		Land between related persons 9	Partnership interest 7
Repossessed property ... 10, 11		Free tax services 16		P		Several assets 6, 12	Stock or securities 2
Bond 4		G		Payments considered		Selling expenses 2	Selling price:
Buyer's note 4		Gross profit percentage 2		received:		Defined 2	Reduced 2
C		Gross profit, defined 2		Buyer assumes debts 4		Single sale of several assets 6, 12	
Contingent payment sale 6		Guarantee 4		Buyer pays seller's expenses 4		T	
Contract price 2		H		Mortgage assumed 4		Tax help (<i>See More information</i>) 16	
D		Help (<i>See More information</i>) 16		Pledge rule 4		Test rate of interest 8	
Dealer sales, special rule 2		I		Pledge rule 4		Third-party note 4	
Depreciation recapture income ... 5		Installment obligation:		Publications (<i>See More information</i>) 16		TTY/TDD information 16	
Disposition of installment obligation 9		Defined 2		R		U	
E		Disposition 9		Related person:		Unstated interest 8	
Electing out 3		Used as security 4		Land sale 9			
Escrow account 5		Installment sale basis 2		Reporting sale to 3, 12			
		Interest:		Sale to 5			
		Escrow account 5		Reporting installment sale 3, 11			
		Income 2		Repossession:			
		Reporting 3					
		Test rate 8					
		Unstated 8					

Tax Publications for Individual Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 1999
- 553 Highlights of 1998 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

Specialized Publications

- 3 Armed Forces' Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 508 Educational Expenses
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 520 Scholarships and Fellowships
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property
- 529 Miscellaneous Deductions

- 530 Tax Information for First-Time Homeowners
- 531 Reporting Tip Income
- 533 Self-Employment Tax
- 534 Depreciating Property Placed in Service Before 1987
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 550 Investment Income and Expenses
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Older Americans' Tax Guide
- 555 Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
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- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
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- 596 Earned Income Credit
- 721 Tax Guide to U.S. Civil Service Retirement Benefits

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- 907 Tax Highlights for Persons with Disabilities
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- 915 Social Security and Equivalent Railroad Retirement Benefits
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- 926 Household Employer's Tax Guide
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- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 IRS Will Figure Your Tax
- 968 Tax Benefits for Adoption
- 970 Tax Benefits for Higher Education
- 971 Innocent Spouse Relief
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A & B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Unreimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch E Supplemental Income and Loss	11344	3903 Moving Expenses	12490
Sch EIC Earned Income Credit	11339	4562 Depreciation and Amortization	12906
Sch F Profit or Loss From Farming	11346	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
Sch H Household Employment Taxes	12187	4952 Investment Interest Expense Deduction	13177
Sch J Farm Income Averaging	25513	5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs	13329
Sch R Credit for the Elderly or the Disabled	11359	6251 Alternative Minimum Tax—Individuals	13600
Sch SE Self-Employment Tax	11358	8283 Noncash Charitable Contributions	62294
1040A U.S. Individual Income Tax Return	11327	8582 Passive Activity Loss Limitations	63704
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8606 Nondeductible IRAs	63966
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8812 Additional Child Tax Credit	10644
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8822 Change of Address	12081
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8829 Expenses for Business Use of Your Home	13232
1040-ES Estimated Tax for Individuals	11340	8863 Education Credits	25379
1040X Amended U.S. Individual Income Tax Return	11360		

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- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

Employer's Guides

- 15 Employer's Tax Guide (Circular E)
- 15-A Employer's Supplemental Tax Guide
- 51 Agricultural Employer's Tax Guide (Circular A)
- 80 Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- 179 Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
- 926 Household Employer's Tax Guide

Specialized Publications

- 378 Fuel Tax Credits and Refunds

- 463 Travel, Entertainment, Gift, and Car Expenses
- 505 Tax Withholding and Estimated Tax
- 510 Excise Taxes for 1999
- 515 Withholding of Tax on Nonresident Aliens and Foreign Corporations
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- 536 Net Operating Losses
- 537 Installment Sales
- 538 Accounting Periods and Methods
- 541 Partnerships
- 542 Corporations
- 544 Sales and Other Dispositions of Assets
- 551 Basis of Assets
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 560 Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)
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- 583 Starting a Business and Keeping Records
- 587 Business Use of Your Home (Including Use by Day-Care Providers)
- 594 Understanding the Collection Process

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- 598 Tax on Unrelated Business Income of Exempt Organizations
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Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
W-2 Wage and Tax Statement	10134	1120S U.S. Income Tax Return for an S Corporation	11510
W-4 Employee's Withholding Allowance Certificate*	10220	Sch D Capital Gains and Losses and Built-In Gains	11516
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234	Sch K-1 Shareholder's Share of Income, Credits, Deductions, etc.	11520
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983	2106 Employee Business Expenses*	11700
941 Employer's Quarterly Federal Tax Return	17001	2106-EZ Unreimbursed Employee Business Expenses*	20604
1040 U.S. Individual Income Tax Return*	11320	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts*	11744
Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330	2441 Child and Dependent Care Expenses*	11862
Sch C Profit or Loss From Business*	11334	2848 Power of Attorney and Declaration of Representative*	11980
Sch C-EZ Net Profit From Business*	14374	3800 General Business Credit	12392
Sch D Capital Gains and Losses*	11338	3903 Moving Expenses*	12490
Sch E Supplemental Income and Loss*	11344	4562 Depreciation and Amortization*	12906
Sch F Profit or Loss From Farming*	11346	4797 Sales of Business Property*	13086
Sch H Household Employment Taxes*	12187	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*	13141
Sch J Farm Income Averaging*	25513	5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*	13329
Sch R Credit for the Elderly or the Disabled*	11359	6252 Installment Sale Income*	13601
Sch SE Self-Employment Tax*	11358	8283 Noncash Charitable Contributions*	62299
1040-ES Estimated Tax for Individuals*	11340	8300 Report of Cash Payments Over \$10,000 Received in a Trade or Business*	62133
1040X Amended U.S. Individual Income Tax Return*	11360	8582 Passive Activity Loss Limitations*	63704
1065 U.S. Partnership Return of Income	11390	8606 Nondeductible IRAs*	63966
Sch D Capital Gains and Losses	11393	8822 Change of Address*	12081
Sch K-1 Partner's Share of Income, Credits, Deductions, etc.	11394	8829 Expenses for Business Use of Your Home*	13232
1120 U.S. Corporation Income Tax Return	11450		
1120-A U.S. Corporation Short-Form Income Tax Return	11456		