**8819. How can an installment sale be used to “fund” a buy-sell agreement?**

Any disposition of property where at least one payment will be received after the close of the tax year of its disposition may be treated as an installment sale.[[1]](#footnote-1) Generally, however, the installment method of taxation (see below) is not available for sales between certain related parties unless they can clearly establish that the transaction was not intended to avoid tax.[[2]](#footnote-2)

Installment sales are often used in the context of a buy-sell agreement where the business owners have not planned in advance to fund the purchase through the use of insurance or otherwise (see Q 8808 and Q 8809), or where the insurance is anadequate to pay the full purchase price. Though installment sales may be used to purchase the interests of a departing business owner, they do not provide the immediate liquidity to the retiring owner or deceased owner’s estate that can be realized through a life insurance strategy or by using accumulated earnings to purchase the interest outright. Practically, an installment sale may be the only means of purchasing a departing business owner’s interests if the buy-sell agreement was not funded in another manner. It is also less secure to the seller in that the earnings of the business are often needed to make the payments under the installment note.

Essentially, an installment sale requires the corporation (or shareholders if the buy-sell agreement is structured as a cross-purchase agreement, see Q 8811) to purchase the interests of the departing business owner using a note, under which it will pay for the interests over time. The departing business owner (or that owner’s estate) reports gain on the sale using the “installment method,” which means that the gain for any given year equals the part of the gain that is actually received (or considered to have been received) during that tax year. The departing business owner must also report as income the amount of the payments received in the year that are deemed to represent interest income. The portion that is deemed to be a return of the owner’s adjusted basis in the interests is excluded as in any other sale.[[3]](#footnote-3) See Q 8548, Q 8768 and Q 8782 for a discussion of determining basis in various contexts.

The departing owner can elect out of the installment sale method and report the entire amount of gain in the year of sale, even though he or she has not yet received all of the proceeds.

The installment method cannot be used if the business interests at issue are securities that are publicly traded on an established market.[[4]](#footnote-4)

**Planning Point:** When drafting the buy sell agreement, consideration should be given to the terms of the note. In some cases, a sample of the note can be attached to the buy sell agreement. Some provisions of the note which should be included within the buy sell agreement include the term, the applicable interest rate, security for the note, whether the note will be personally guaranteed and a “due on sale clause” to ensure that the note will be satisfied if the business is sold while the note is outstanding.

1. . IRC Sec. 453(b)(1). [↑](#footnote-ref-1)
2. . IRC Sec. 453(g)(2). If the buyer disposes the asset within 2 years of the purchase, there are additional restrictions in IRC Sec. 453(e), also called the anti-Rushing Rule, see *Rushing v Comm.*, 441 F.2d 593 (1971). [↑](#footnote-ref-2)
3. . See IRS Publication 537. [↑](#footnote-ref-3)
4. . IRS Pub. 537, above. [↑](#footnote-ref-4)