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Sidestep this installment sale trap

If you're looking to sell real estate, you may have to structure the deal to make it acceptable to the buyer. But this could work to your tax advantage.

Strategy: Arrange a year-end "installment sale." If payments are made in the year of the sale and at least one other year, you don't owe all the tax due on a gain. Not only does this defer tax, it might reduce your overall tax liability.

However, you must watch out for a tax trap for sales to "related parties." Fortunately, it's relatively easy to avoid dire tax results.

Here's the whole story: Under the installment sale reporting rules, only a portion of the gain is taxable in the year in which you receive a payment. Also, the taxable portion on the sale usually qualifies for favorable capital gain treatment.

Currently, the maximum tax rate for long-term capital gains is 15% or 20% for taxpayers in the highest ordinary income tax bracket of 39.6%. In addition, a 3.8% Medicare surtax applies to the lesser of net investment income (NII), which includes most sales of rental real estate properties, or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold of $250,000 for joint filers (or MAGI of $200,000 for single filers). *Note:* These figures are not indexed for inflation.

Thus, you could pay an effective tax rate of 23.8% (20% + 3.8%) on the sale of highly appreciated long-term capital gain property in 2017.

The taxable portion of the payment is based on the "gross profit ratio." Gross profit ratio is determined by dividing the gross profit from the real estate sale by the contract price.

Example: Let's say you acquired commercial real estate several years ago that now has an adjusted basis of $600,000. On Dec. 15, 2017, you agree to sell the property for $1.5 million in five annual installments of $300,000 each, starting in 2017. Because your gross profit is $900,000 ($1.5 million - $600,000), the taxable percentage of each installment received is 60% ($900,000 divided by $1.5 million). When you report the sale on your 2017 tax return, you're only taxed on $180,000 of gain (60% of the $300,000 received in 2017), reducing your exposure to the 20% capital gains rate and the NII tax.

For simplicity, let's say you save the 5% capital gains differential on $100,000 of income each year. That's a tax savings of $25,000 (5% of $500,000)—well worth the wait.

Caveat: The tax law says you can't sell property using the installment method to a related party unless you can demonstrate that the deal wasn't motivated by tax avoidance. Furthermore, if the related party resells or otherwise disposes of the property within two years, the remaining gain must be recognized immediately.

The definition of a "related party isn't limited to the usual family members like your spouse, children, grandchildren, siblings and parents. It also includes a partnership or corporation you own or an estate or trust that you're connected to.

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The easiest way to handle this is to ensure that the related party doesn't dispose of the property within two years. Spell it out as a requirement in the contract.

Tip: If the sales price of your property (other than farm property or personal property) exceeds $150,000, interest must be paid on the deferred tax if your total outstanding installment receivables exceed $5 million.

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