

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8836]

RIN 1545-AW85

Capital Gains, Installment Sales, Unrecaptured Section 1250 Gain

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the taxation of capital gains on installment sales of depreciable real property. The regulations interpret changes made by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998 and the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999. The regulations affect persons required to report capital gain from an installment sale where a portion of the capital gain is unrecaptured section 1250 gain and a portion is adjusted net capital gain.

DATES: Effective Date: These regulations are effective August 23, 1999.

Applicability Date: These regulations apply to installment payments properly taken into account after August 23, 1999.

FOR FURTHER INFORMATION CONTACT: Susan Kassell, (202) 622-4930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document contains amendments to the Income Tax Regulations (26 CFR Part 1). On January 22, 1999, a notice of proposed rulemaking relating to the taxation of capital gains on installment sales of depreciable real property was published in the **Federal Register** (64 FR 3457). No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations are adopted without substantive change by this Treasury decision.

#### **Explanation of Provisions**

In 1997 Congress amended section 1(h) generally to reduce the maximum capital gain tax rates for individuals. As amended, section 1(h) generally divides a taxpayer's net capital gain into several rate groups. A maximum marginal rate of 28 percent applies to 28-percent rate gain, which is not pertinent to these final regulations. A maximum marginal rate of 25 percent applies to unrecaptured section 1250 gain (25-percent gain), which is defined in section 1(h)(7)(A) as the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, reduced by any net loss in the 28-percent rate category. A maximum marginal rate of 20 percent applies to adjusted net capital gain (20/10-percent gain), defined in section 1(h)(4) as the portion of net capital gain that is not taxed at the 28-percent or 25-percent rates. A reduced rate of

10 percent is applied to the portion of the taxpayer's adjusted net capital gain that would otherwise be taxed at a 15-percent rate.

Under the final regulations, if a portion of the capital gain from an installment sale of real depreciable property consists of 25-percent gain, and a portion consists of 20/10-percent gain, the taxpayer is required to take the 25-percent gain into account before the 20/10-percent gain, as payments are received. In addition, an example in the regulations illustrates that section 1231 gain from an installment sale that is recharacterized as ordinary gain under section 1231(c) is deemed to consist first of 25-percent gain, and then 20/10-percent gain. Consistent with this treatment and with the general rule that 25-percent gain is taken into account first, another example in the regulations illustrates that, where there is installment gain that is characterized as ordinary gain under section 1231(a) because there is a net section 1231 loss for the year, the gain is treated as consisting of 25-percent gain first, before 20/10-percent gain, for purposes of determining how much 25-percent gain remains to be taken into account in later payments.

The final regulations also provide that the capital gain rates applicable to installment payments that are received on or after the effective date of the 1997 Act from sales prior to the effective date are determined as if, for all payments received after the date of sale but before the effective date, 25-percent gain had been taken into account before 20/10-percent gain. The

regulations further provide that, in the event the cumulative amount of 25-percent gain actually reported in installment payments received during the period between the effective date of section 1(h) and the effective date of these regulations was less than the amount that would have been reported using the front-loaded allocation method of the regulations, the amount of 25-percent gain actually reported, rather than an amount determined under a front-loaded allocation method, must be used in determining the amount of 25-percent gain that remains to be reported.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Drafting Information**

The principal authors of these regulations are Susan Kassell and Rob Laudeman, Office of Assistant Chief Counsel (Income Tax &

Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.453-12 is added to read as follows:

§1.453-12 Allocation of unrecaptured section 1250 gain reported on the installment method.

(a) General rule. Unrecaptured section 1250 gain, as defined in section 1(h)(7), is reported on the installment method if that method otherwise applies under section 453 or 453A and the corresponding regulations. If gain from an installment sale includes unrecaptured section 1250 gain and adjusted net capital gain (as defined in section 1(h)(4)), the unrecaptured section 1250 gain is taken into account before the adjusted net capital gain.

(b) Installment payments from sales before May 7, 1997. The amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, from a sale before May 7, 1997, is determined as if, for all payments properly taken into account after the date of sale but

before May 7, 1997, unrecaptured section 1250 gain had been taken into account before adjusted net capital gain.

(c) Installment payments received after May 6, 1997, and on or before August 23, 1999. If the amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, and on or before August 23, 1999, is less than the amount that would have been taken into account under this section, the lesser amount is used to determine the amount of unrecaptured section 1250 gain that remains to be taken into account.

(d) Examples. In each example, the taxpayer, an individual whose taxable year is the calendar year, does not elect out of the installment method. The installment obligation bears adequate stated interest, and the property sold is real property held in a trade or business that qualifies as both section 1231 property and section 1250 property. In all taxable years, the taxpayer's marginal tax rate on ordinary income is 28 percent. The following examples illustrate the rules of this section:

Example 1. General rule. This example illustrates the rule of paragraph (a) of this section as follows:

(i) In 1999, A sells property for \$10,000, to be paid in ten equal annual installments beginning on December 1, 1999. A originally purchased the property for \$5000, held the property for several years, and took straight-line depreciation deductions in the amount of \$3000. In each of the years 1999-2008, A has no other capital or section 1231 gains or losses.

(ii) A's adjusted basis at the time of the sale is \$2000. Of A's \$8000 of section 1231 gain on the sale of the property, \$3000 is attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain. The gain on each installment payment is \$800.

(iii) As illustrated in the table in this paragraph (iii) of this Example 1., A takes into account the unrecaptured section 1250 gain first. Therefore, the gain on A's first three payments, received in 1999, 2000, and 2001, is taxed at 25 percent. Of the \$800 of gain on the fourth payment, received in 2002, \$600 is taxed at 25 percent and the remaining \$200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

|                              | 1999 | 2000 | 2001 | 2002 | 2003 | 2004-2008 | Total gain |
|------------------------------|------|------|------|------|------|-----------|------------|
| Installment gain             | 800  | 800  | 800  | 800  | 800  | 4000      | 8000       |
| Taxed at 25%                 | 800  | 800  | 800  | 600  |      |           | 3000       |
| Taxed at 20%                 |      |      |      | 200  | 800  | 4000      | 5000       |
| Remaining to be taxed at 25% | 2200 | 1400 | 600  |      |      |           |            |

Example 2. Installment payments from sales prior to May 7, 1997. This example illustrates the rule of paragraph (b) of this section as follows:

(i) The facts are the same as in Example 1 except that A sold the property in 1994, received the first of the ten annual installment payments on December 1, 1994, and had no other capital or section 1231 gains or losses in the years 1994-2003.

(ii) As in Example 1, of A's \$8000 of gain on the sale of the property, \$3000 was attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain.

(iii) As illustrated in the following table, A's first three payments, in 1994, 1995, and 1996, were received before May 7, 1997, and taxed at 28 percent. Under the rule described in paragraph (b) of this section, A determines the allocation of unrecaptured section 1250 gain for each installment payment after May 6, 1997, by taking unrecaptured section 1250 gain into account first, treating the general rule of paragraph (a) of this section as having applied since the time the property was sold, in 1994. Consequently, of the \$800 of gain on the fourth payment, received in 1997, \$600 is taxed at 25 percent and the remaining \$200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

|                              | 1994 | 1995 | 1996 | 1997 | 1998 | 1999-2003 | Total gain |
|------------------------------|------|------|------|------|------|-----------|------------|
| Installment gain             | 800  | 800  | 800  | 800  | 800  | 4000      | 8000       |
| Taxed at 28%                 | 800  | 800  | 800  |      |      |           | 2400       |
| Taxed at 25%                 |      |      |      | 600  |      |           | 600        |
| Taxed at 20%                 |      |      |      | 200  | 800  | 4000      | 5000       |
| Remaining to be taxed at 25% | 2200 | 1400 | 600  |      |      |           |            |

Example 3. Effect of section 1231(c) recapture. This example illustrates the rule of paragraph (a) of this section when there are non-recaptured net section 1231 losses, as defined in section 1231(c)(2), from prior years as follows:

(i) The facts are the same as in Example 1, except that in 1999 A has non-recaptured net section 1231 losses from the previous four years of \$1000.

(ii) As illustrated in the table in paragraph (iv) of this Example 3, in 1999, all of A's \$800 installment gain is recaptured as ordinary income under section 1231(c). Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, the \$800 recaptured as ordinary income under section 1231(c) is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has \$2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A's installment gain is taxed at two rates. First, \$200 is recaptured as ordinary income under section 1231(c). Second, the remaining \$600 of gain on A's year 2000 installment payment is taxed at 25 percent. Because the full \$800 of gain reduces unrecaptured section 1250 gain, A has \$1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent. Of the \$800 of gain on the fourth payment, received in 2002, \$600 is taxed at 25 percent and the remaining \$200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as



follows:

|  | 1999 | 2000 | 2001 | 2002 | 2003 | 2004-2008 | Total gain |
|--|------|------|------|------|------|-----------|------------|
| Installment gain                                 | 800  | 800  | 800  | 800  | 800  | 4000      | 8000       |
| Taxed at ordinary rates under section 1231(c)    | 800  | 200  |      |      |      |           | 1000       |
| Taxed at 25%                                     |      | 600  | 800  | 600  |      |           | 2000       |
| Taxed at 20%                                     |      |      |      | 200  | 800  | 4000      | 5000       |
| Remaining non-recaptured net section 1231 losses | 200  |      |      |      |      |           |            |
| Remaining to be taxed at 25%                     | 2200 | 1400 | 600  |      |      |           |            |

Example 4. Effect of a net section 1231 loss. This example illustrates the application of paragraph (a) of this section when there is a net section 1231 loss as follows:

(i) The facts are the same as in Example 1 except that A has section 1231 losses of \$1000 in 1999.

(ii) In 1999, A's section 1231 installment gain of \$800 does not exceed A's section 1231 losses of \$1000. Therefore, A has a net section 1231 loss of \$200. As a result, under section 1231(a) all of A's section 1231 gains and losses are treated as ordinary gains and losses. As illustrated in the following table, A's entire \$800 of installment gain is ordinary gain. Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, A's \$800 of ordinary section 1231 installment gain in 1999 is treated as reducing unrecaptured section 1250 gain. Therefore, A has \$2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A has \$800 of section 1231 installment gain, resulting in a net section 1231 gain of \$800. A also has \$200 of non-recaptured net section 1231 losses. The \$800 gain is taxed at two rates. First, \$200 is taxed at ordinary rates under section 1231(c), recapturing the \$200 net section 1231 loss sustained in 1999. Second, the remaining \$600

of gain on A's year 2000 installment payment is taxed at 25 percent. As in Example 3, the \$200 of section 1231(c) gain is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has \$1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent, reducing the remaining unrecaptured section 1250 gain to \$600. Of the \$800 of gain on the fourth payment, received in 2002, \$600 is taxed at 25 percent and the remaining \$200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

|   | 1999 | 2000 | 2001 | 2002 | 2003 | 2004-<br>2008 | Total<br>gain |
|---|------|------|------|------|------|---------------|---------------|
| Installment gain                              | 800  | 800  | 800  | 800  | 800  | 4000          | 8000          |
| Ordinary gain under section 1231(a)           | 800  |      |      |      |      |               | 800           |
| Taxed at ordinary rates under section 1231(c) |      | 200  |      |      |      |               | 200           |
| Taxed at 25%                                  |      | 600  | 800  | 600  |      |               | 2000          |
| Taxed at 20%                                  |      |      |      | 200  | 800  | 4000          | 5000          |
| Net section 1231 loss                         | 200  |      |      |      |      |               |               |
| Remaining to be taxed at 25%                  | 2200 | 1400 | 600  |      |      |               |               |

(e) Effective date. This section applies to installment payments properly taken into account after August 23, 1999.

Deputy Commissioner of Internal Revenue

Approved:

Assistant Secretary of the Treasury