Section 453A – Interest on Deferred Tax Liability

Section 453A imposes an interest charge to a disposition of property under the installment method when the sales price of the property exceeds $150,000 (the "**453A Obligation**").

Interest is imposed on a 453A Obligation arising during a taxable year only if (1) the obligation is outstanding as of the close of the taxable year, and (2) the face amount of all 453A Obligations held by the seller that arose during, and are outstanding as of the close of, that taxable year exceeds $5 million.

Section 453A(c)(1) provides that the taxpayer's income tax is increased by the interest charge. The interest charge is reported on the taxpayer's Form 1040, U.S. Individual Income Tax Return.

The $5 million threshold is applied and calculated at the partner or shareholder level for all passthrough entities.

Section 453A(c)(5) further states that any amount paid under this section is taken into account in computing the amount of the taxpayer's interest deduction for the tax year. The interest is subject to the rules that dictate whether interest incurred on tax underpayments is deductible by the taxpayer. A number of court cases, as well as Section 163 and related Temp. Regs. Sec. 1.163-9T(b)(2)(i)(A), take the position that interest on an individual underpayment of federal income tax is nondeductible personal interest regardless of whether the tax liability is from a business or investment activity.

Therefore, for individual taxpayers, the Section 453A interest charge is considered nondeductible personal interest. But C corporations are allowed to deduct the interest charge as a business expense in most circumstances in the year paid or accrued because C corporations are not subject to the limitations on deductions for personal interest expense.

Criteria

1. Did the seller report gain from the sale of property under the Section 453 installment method of accounting?
    a. The seller must report gain from the sale of property under the installment method for Section 453A to be applicable.
    b. The seller uses a separate Form 6252 for each installment sale or other disposition of property on the installment method.
2. Did the sales price of the property exceed $150,000?
    a. The sales price of the property must exceed $150,000 for Section 453A to be applicable.
    b. Review the Form 6252 to identify an installment sale with a sales price exceeding $150,000.
    c. In determining the sales price, treat all sales that are part of the same transaction (or series of related transactions) as one sale.
3. Is the installment obligation to which Section 453A applies outstanding as of the close of the taxable year?

   a. The obligation must be outstanding as of the close of the taxable year for Section 453A to apply.

4. Did the face amount of all installment obligations to which Section 453A applies, that arose during and were outstanding as of the close of that taxable year, exceed $5 million?
   a. Section 453A is only applicable when the face amount of all installment obligations that arose during and outstanding as of the close of that taxable year exceeds $5 million.

<u>Computation Example</u>

- During the tax year, an individual sold stock for $32 million with an adjusted basis of $4 million.
- The taxpayer received $5 million during the year and will receive the $27 million balance over the next four years.
- Section 453A applies since the sales price exceeds $150,000 and the face amount of the obligation at the end of the taxable year exceeds $5 million.
- Step 1: Compute the Gross Profit Percentage.
  - $28 million Gross Profit divided by $32 million Selling Price equals 88%.
- Step 2: Compute the Unrecognized Gain at Year-End.
  - $27 million Outstanding Installment Obligation multiplied by the 88% Gross Profit Percentage equals $23.62 million.
- Step 3: Compute the Deferred Tax Liability.
  - $23.62 million Unrecognized Gain at Year-End multiplied by the 37% maximum tax rate for an individual equals $8.74 million.
- Step 4: Determine the applicable percentage.
  - The applicable percentage is the ((Aggregate Face Amount of Outstanding Obligations less $5 million) / (Aggregate Face Amount of Outstanding Obligations))
  - The interest computation is the same whether a sale occurred on the last day of the taxable year or on any other day during the taxable year.
  - This applicable percentage does not change as payments are made in later taxable years.
  - The aggregate amount of Outstanding Installment Obligations outstanding at year-end is $27 million. The Applicable Percentage is $22 million / $27 million = 81%.
- Step 5: Determine the Underpayment Rate under Section 6621(a)(2) for the interest that will be charged.
  - The Section 453A interest computation is based on the Section 6621(a)(2) rate for the final month of the taxable year, which is the interest rate in effect as of the last day of the seller's taxable year.
  - The Section 6621(a)(2) underpayment rate is 3% over the federal short-term rate, which is determined by the Treasury Department on a monthly basis.
- Step 6: Compute the interest on the deferred tax liability by multiplying the deferred tax liability by the applicable percentage and by the underpayment rate.
  - Deferred Tax Liability * Applicable Percentage * Underpayment Rate = Interest on Deferred Tax Liability
  - $8.74 million * 81% * 7% = $498,575

Recommendations

1. Consider Section 453A when analyzing installment sale transactions and advise clients of the interest charge, which is an additional economic cost of entering into the installment obligation.
2. In Technical Advice Memorandum 9853002, the IRS ruled that married individuals are not treated as one person in calculating the $5 million threshold. Since each spouse will receive his or her own $5 million threshold in the calculation of the interest charge, a gift of the target property from one spouse to another effectively doubles the threshold amount.