

City of Philadelphia – Department of Revenue

Policy Statement regarding the Installment Sale of Real Estate for purposes of the Business Income and Receipts Tax (BIRT) and the Net Profits Tax (NPT)

Introduction

Historically, the City of Philadelphia’s Department of Revenue (“Department”) has received many inquiries as to the proper reporting of the installment sale of real estate for purposes of the BIRT and NPT returns. This policy statement will clarify the Department’s position as it applies to the installment sale of real estate only. The installment sale of any other property is beyond the scope of this policy.

This policy will also briefly address the Federal income tax reporting of the installment sale of real estate and address the various provisions of the Department’s regulations that would impact the policy contained herein.

BIRT and NPT Reporting for Taxpayers Reporting the Capital Gain from the Sale of Real Estate using the Federal Installment Sale method

During the collection of the installment note, the taxpayer’s Philadelphia Business Tax Account number is to remain active. The installment capital gain and interest income generated on the note is to be reported on the BIRT return (both Gross Receipts and Net Income Bases – Methods I and II) and on the NPT return for the life of the note regardless of the existence of other business activity.

Federal Tax Reporting of Installment Sales of Real Estate

An installment sale is a sale of property where at least one payment is received by the seller after the tax year in which the sale occurs. The installment method of reporting is mandatory in the case of an installment sale. Installment sale reporting enables a taxpayer to report his or her gain proportionally as he or she receives payments under the installment agreement. Without an installment sale treatment a taxpayer would be required to report the entire gain in the year of the sale of the property. An installment sale only requires that at least one payment be received in a future tax year.

When a seller receives a payment under the installment sale, he or she receives funds that must be divided into three (3) parts. Those parts are first allocated to the interest due under the note or imputed, then to the return of the basis of the property and then to the gain on the sale. A taxpayer must report interest income under an installment sale as ordinary income. If the installment agreement does not have a stated interest rate, then the seller must impute an interest rate. After a seller has determined what interest is due or imputed he or she is able to determine the selling price. The gain reported in any given year under the installment method is equal to the total payments received during the year (other than interest) multiplied by the installment sale calculated 'gross profit percentage.' It does not matter how the future payments are structured, whether done under a deed of trust, note, land contract, mortgage and/or any other form. The form does not matter.

For Federal income tax purposes, installment sales are reported on Form 6252, Installment Sale Income. This form must be completed and attached to the taxpayer's Federal tax return in any year that property is sold in a qualifying installment sale and in any year that the taxpayer receives a payment from an installment sale, assuming the taxpayer did not choose to elect out of the installment method.

As noted above, the seller can elect not to use the installment sales method. An election out of the installment method must be made by the due date of the taxpayer's return, including extension, for the year in which the sale occurs. A taxpayer elects out of the installment sale by fully reporting the total amount of the sale and gain on Form 4797, Sales of Business Property;

Form 8949, Sales and Other Dispositions of Capital Assets; or Schedule D, Capital Gain or Loss, depending on the asset type. No other form or special election statement is required.

Philadelphia Regulations that Impact the Use of the Installment Sales Method

BIRT Regulations Section 104. Complete Termination or Liquidation of a Business

Liquidation of a business is a taxable activity. A business is deemed to continue engaging in business until all of its normal operations which produce revenue have ceased. In the case of a business which owns inventory, normal operations are deemed to continue until all inventory is liquidated. For the purpose of determining when a business has terminated, the mere collection of accounts receivable or notes receivable by a person who is not engaged in the business of lending money, during the process of liquidation, does not constitute engaging in a taxable activity; however, income received prior to cessation of normal operations must be included in the measure of the tax for any business which continues into the following tax year. For due date of filing and for the period used to file termination/final tax year return, refer to Sections 202 and 203 of this Regulation.

Revenue Department's Policy Position - Business Activity Continues

The Revenue Department's position is that where the seller of real estate agrees to hold a note and receive the payment for the property in installments so as to use the installment method for Federal income tax purposes, the presumption is that the seller has converted its business activity from that of a real estate investor (i.e. renting, holding property, etc.) to one that provides for the lending of money. As such, the taxpayer's business activity (and the requirement to file the applicable BIRT and NPT returns) will continue until the tax period when the final payment on the note is received (presuming the taxpayer is not engaged in any other taxable business activity).

BIRT Regulations Section 307. Conditional and Installment Sales.

(A) A person making conditional sales or other installment sales of property is required to report the total selling price of such sales as gross receipts for the tax year in which the contracts of sale are entered into, without regard to the fact that the seller may arrange to receive payment from the purchaser on an installment basis, or that such contracts may be discounted or pledged with, or sold to, a finance company.

(B) Property Repossessed. Where tangible personal property sold under a conditional or other installment sales contract is repossessed by the seller, and the repossessed property is subsequently sold, the receipts from such sales are to be included in the measure of the tax only to the extent that the amount of the sale exceeds the balance due on the original sale at the time of repossession. No deduction from gross receipts may be taken for any unpaid balance due at the time of repossession.

Revenue Department's Policy Position - Installment Capital Gain and Interest Income Reported for the BIRT Gross Receipts Base over the life of the Installment Note.

Notwithstanding the requirement to report the full gain in the BIRT Gross Receipts base in the year of sale, the Department's position is to allow the use of the installment sale methodology in the sale of real estate for purposes of the BIRT Gross Receipts base tax. The installment gain recognized for Federal income tax purposes will be reported in the BIRT Gross receipts tax base. In addition, the interest collected on the installment note will also be reported for purposes of the BIRT Gross receipts tax base.

BIRT Regulations Section 324. Sale of Capital Assets.

Except as otherwise provided, the gains (not gross proceeds) resulting from the sale of capital assets, such as plant, machinery and equipment, furniture and fixtures, vehicles, etc., are to be included in the tax base if the property is located in Philadelphia at the time of the sale. Losses

sustained on such sales may be offset against gains from other sales of capital assets, but may not be offset against gross receipts from other sources. In computing the gains or losses from the sale of a capital asset, the cost of the asset, less allowable depreciation, is deductible from the gross proceeds of the sale.

Revenue Department’s Policy Position - Philadelphia Real Estate – Full Capital Gain to be Reported for the BIRT over the life of the Installment Note

Ultimately, the full gain on the sale of real estate located within the City of Philadelphia that was used for a business purpose (i.e. rental activity, etc.) is to be reported in the BIRT Gross Receipts base tax over the course of receiving the installment note payments. This will be the case despite there being no other business activity aside from the collection of the note payments.

BIRT Regulations Section 404. Net Income Method II.

(A) General.

1) Method II Net Income shall be the portion of the taxpayer's adjusted taxable income (or loss) from any business activity as properly returned to and ascertained by the Federal Government prior to giving effect to the exclusion for dividends received and for net operating losses, which is apportioned to Philadelphia, plus the taxpayer's nonbusiness income which is allocated to Philadelphia. The adjustments to taxable income (or loss) are provided in subsections (B)(1) through (B)(6).

2) Taxable income as properly returned to the Federal Government means the taxable income (or loss) as should have been reported to the Internal Revenue Service on a tax return form, in accordance with the Internal Revenue Code, the Regulations issued thereunder, applicable rulings and court decisions....

Revenue Department’s Policy Position - Use of the Installment Sale Method for Federal Income Tax Purposes is to be recognized for BIRT Method II filers.

The overwhelming majority of taxpayers filing the BIRT use Net Income Method II (i.e. Federal taxable income) and the Department is required by the Philadelphia Code and the regulations promulgated thereunder to adhere to the Internal Revenue Code provisions that calculate Federal taxable net income before giving effect for the dividends received deduction and net operating loss. Therefore, the use of the Federal installment sale methodology for taxpayers electing its use on their Federal income tax returns must be honored by the Department for BIRT Method II filers.

Income Tax Regulations Section 303. Returns and Deposits Required to be Filed.

b) Returns by Persons Engaged in Business, Professions, etc.

1) Annual Returns of Net Profits Tax

c) Basis Used in Filing Return

a. Cash

b. Accrual

c. Long-term Contract or Installment

If the books and records of the taxpayer are kept on an "accrual," "long-term contract," or "installment" basis and this basis is used in the filing of the Federal Income Tax Return, such basis must be used for the purpose of this tax.

The taxpayer may not change from an accrual to a cash basis, or vice-versa, without written permission first being obtained from the Department of Revenue.

The method shall reflect the gain (or loss) resulting from the activity of a business, profession, or enterprise which occurs during the usual operations; inclusive of the sale, exchange, or

disposition of assets of an ongoing or terminated entity. Transactions must be identifiable, necessary, and reasonable to the business, after allowance for applicable costs.

BIRT Regulations Section 403. Net Income Method I.

Net Income Method I

(A) General.

Method I Net Income shall be the net gain from the operation of a business, profession or other activity after provision for all allowable expenses actually incurred in the conduct thereof, either paid or accrued in accordance with the accounting system used, without deduction of taxes based on income, and without deduction of fines and penalties, and as allocated and apportioned as provided in this Article and after adjustment for the distributive share of net income or loss received by one partner from a partnership where the receiving partner's ownership of capital at the end of the year is at least twenty-percent (20%) as reported on Schedule K-1 of Federal Form 1065 of the distributing partnership. The rules and regulations applicable to determining taxable net profits for the Net Profits tax imposed in Chapter 19-1500 of The Philadelphia Code shall be the rules and regulations applicable to determining taxable net income for Net Income Method I.

Revenue Department's Policy Position - Use of the Installment Sale Method is to be recognized for NPT and BIRT Method I filers.

BIRT Regulations Section 403 (A) require that the rules and regulations that apply to the NPT for determining taxable income also apply to the taxpayers using BIRT Net Income Method I (i.e. book Income). If the taxpayer is using an installment method for the reporting of the capital gain for purposes of its books and records, this method must also be used for NPT and BIRT Method I reporting purposes.