



Consider an installment sale to optimize taxes when selling your business

Over the years, you've invested blood, sweat and tears into building a successful small business. Now it's time to sell and move on to the next chapter of your life. What are the tax implications of selling — and how can you reduce or defer your taxes? One possible solution is an installment sale.

How it works

With an installment sale, you don't receive a lump-sum payment when the deal closes. Instead, you receive installment payments over time. Typically, the buyer makes a down payment at closing and issues a note requiring principal and interest payments over an agreed-upon period. Each principal payment generally includes a tax-free return of basis and taxable gain, while the interest is taxed separately as ordinary income. This spreads your gain over several years.

It's important to note that the rules are more complicated when a deal is structured as an asset sale rather than a sale of an ownership interest. Installment sales are still possible for eligible assets included in an asset sale, but you must allocate the purchase price among the business's assets and calculate each asset's gain or loss separately. If you're contemplating an asset sale, we can provide more details.

Potential tax benefits

Generally, installment sale gains qualify as low-taxed long-term capital gain or as Section 1231 gain for sales of property held for business purposes. Sec. 1231 gains are usually also taxed at the lower long-term capital gains rates. The 3.8% net investment income tax (NIIT) and state income tax may apply, too.

An installment sale generally *defers* tax, because you pay most of the tax liability as you receive the payments. It may also *reduce* your overall tax obligation from the transaction if the arrangement allows you to stay under the thresholds for triggering the 20% long-term capital gains rate or the NIIT for each tax year of the note's term.

For 2026, the 20% long-term capital gains rate kicks in when taxable income exceeds:

- \$545,500 for single filers,
- \$579,600 for heads of households,
- \$613,700 for married couples who file jointly, and
- \$306,850 for married filing separately.

If your taxable income for the tax year is below the applicable threshold, you'll likely pay 15% on your long-term capital gains. However, if your taxable income for the tax year is modest, you could pay *no* federal long-term capital gains tax. For 2026, the 0% rate applies to those with taxable income up to \$49,450 (single and separate filers), \$66,200 (heads of households) and \$98,900 (joint filers).

For 2026, taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 for joint filers and \$125,000 for separate filers) may owe NIIT on some or all of their investment income.

Beyond taxes

An installment sale also might help you close a deal or get a better price for your business. For instance, an installment sale might appeal to a buyer that lacks sufficient cash to pay the price you're looking for in a lump sum.

Or a buyer might be concerned about the ongoing success of your business without you at the helm or because of changing market conditions or other economic factors. An installment sale that includes a contingent amount based on the business's performance might be the solution.

Of course, you should evaluate the buyer's credit risk before entering into an installment arrangement. Consider collateral, personal guarantees and other protections. Your note may also be subordinated to financing provided by the buyer's bank.

Beware of potential tax pitfalls

An installment sale isn't without tax risk for sellers. For example, you must report depreciation recapture as a gain in the year of sale, no matter how much cash you receive.

Depreciation recapture generally results from deductions previously claimed for the property. It may be taxed at ordinary income tax rates, which can be as high as 37%. But in the case of certain depreciated real property, the maximum federal rate on depreciation recapture is generally 25%. The 3.8% NIIT and state income tax may apply, too. If depreciation recapture is an issue, you could owe tax that year without receiving enough cash proceeds from the sale to pay the tax.

Also, beware: If the installment note doesn't charge adequate interest on the deferred principal payments, the complicated original issue discount (OID) rules can transform some of the payments from principal to interest. That's unfavorable because interest income recognized by an individual taxpayer is taxed at higher ordinary income rates.

Finally, today's federal tax rates are relatively low compared to historical rates. If Congress passes legislation that increases the long-term capital gains or NIIT rates (or lowers the applicable thresholds), you could wind up paying more overall tax on your gain from the sale. Weigh this risk carefully against the potential benefits of an installment sale.

One size doesn't fit all transactions

As you can see, installment sales have both pros and cons. To determine whether one is right for you and your business — and find out about other tax-smart options — please contact us.