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THE INSTALLMENT SALES REVISION ACT OF 1980

HERBERT J. LERNER

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On October 19, 1980, President Carter signed into law the "Installment Sales Revision Act of 1980" (P.L. 96-471), thus culminating nearly two years of cooperative effort by both the public and private sectors in revising the federal income tax treatment of installment sales. The Act demonstrates the advances in tax simplification and revision that can be achieved when the input of these two sectors is concentrated on a common goal. In general, the Act simplifies and clarifies the provisions associated with the installment method of reporting gains from sales of realty or nondealer sales of personal property. In addition, the Act prescribes special rules for sales of property between related parties and distributions of certain installment obligations in twelve-month corporate liquidations. It also eliminates the complicated double inclusion of income treatment when a dealer elects the installment method.

The Act's Historical Perspective

The effort by the Congress to simplify the rules relating to the method of reporting deferred payment sales began in May of 1979 with the

introduction of two identical bills, S. 1063 and H.R. 3899.¹ The bills as originally introduced would have: eliminated the requirement that no more than 30 percent of the selling price be received in the taxable year of sale; increased the floor amount from \$1,000 to \$3,000 on casual sales of personal property subject to the installment method; made installment reporting automatic rather than elective; provided that the recognition of gain from an installment sale could not be avoided by bequeathing an installment obligation to the obligor; and, denied installment reporting for sales between related parties.

In June and July of 1979, the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee and the Select Revenue Measures Subcommittee of the House Ways and Means Committee held hearings on these bills.² The comments made at these hearings generally were favorable; however, the proposal was criticized with respect to its treatment of related party transactions and it was recommended that any legislation concerning the installment sales provisions have a broader focus with the intention of simplifying the entire installment sale area for non-dealers.

Motivated by the comments made at the Subcommittee hearings, the public and private sectors embarked upon a joint effort to recommend changes which would both simplify and reform the installment sales provisions. Participants included staff members of the congressional tax-writing committees, the Treasury Department, the American Institute of Certified Public Accountants, the American Bar Association, and New York State and City Bar Associations. The result of this collaboration was the introduction, on March 19, 1980, of two new bills, H.R. 6883 and S. 2451.³

Initially, these bills contained the following substantive changes for nondealers, all of which were subsequently adopted:

1. Provided that installment reporting would be automatic, with the option to elect non-installment treatment when desirable.
2. Eliminated the 30-percent initial payment limitation for reporting gain from the disposition of real property or the casual sale of personal property.
3. Eliminated the \$1,000 sales price floor requirement for installment reporting of casual sales of personal property.

¹ S. 1063, 96th Cong., 1st Sess. (1979); H.R. 3899, 96th Cong., 1st Sess. (1979). Introduced by Senators Long and Dole, and Representatives Ullman and Conable, respectively.

² *Simplification of Installment Sale Reporting Rules: Hearing on S. 1062 and S. 1063 Before the Subcomm. on Taxation and Debt Mgmt. Generally of the Comm. on Finance on June 22, 1979, 96th Cong., 1st Sess. (1979)*; *Simplification of Installment Sale Reporting Rules: Hearing on H.R. 3899 and H.R. 3900 Before the Subcomm. on Select Rev. Measures of the Comm. on Ways and Means on July 27, 1979, 96th Cong., 1st Sess. (1979)*.

³ Introduced by Representatives Ullman, Rostenkowski, Conable, and Duncan and Senators Long and Dole, respectively. See 126 Cong. Rec. H2003 (daily ed. March 19, 1980) (remarks of Rep. Ullman); 126 Cong. Rec. S2656 (daily ed. March 19, 1980) (remarks of Sen. Long).

4. Eliminated the requirement that a sales agreement provide for two or more payments.
5. Restricted the use of installment reporting for certain related party sales.
6. Permitted the use of installment reporting for certain installment obligations received in a Section 337 liquidation.
7. Permitted the use of installment reporting for sales which contain a contingent element for all or part of the contract price.
8. Provided that the receipt of like-kind property in connection with a disposition would not be used to accelerate the gain recognized for installment sale reporting purposes.
9. Triggered recognition of the deferred gain associated with an installment obligation upon the cancellation of, or failure to enforce, an installment obligation.
10. Applied the installment sale disposition rules to the transfer of an installment obligation by bequest, devise, or inheritance to the obligor.
11. Permitted Section 1038 treatment to be used by the estate of a deceased taxpayer who, prior to his death, had sold real property using the installment method.

Although these new bills were a vast improvement over the initial proposals, after additional hearings were held, the following amendments were made by the Senate⁴ and subsequently adopted by the House as part of the Act:

1. Third party guarantees (including a standby letter of credit) used as security for a deferred payment sale will not be treated as a payment received by the seller.
2. Applies the corporate constructive ownership rules for purposes of characterizing the nature of income realized from installment sales of depreciable property between related parties.
3. Applies the general non-recognition rule regarding tax-free dispositions of installment obligations to tax-free transfers to life insurance companies.
4. The election of installment method reporting by an accrual method dealer would apply only to payments received from sales made on or after the effective date of the election, thereby eliminating the double inclusion problems of prior law.

As part of the move to simplification of the installment sales area, it was believed that certain structural improvements should be made to the existing law. Under prior law, a single provision, Section 453 of the Internal Revenue Code, as amended,⁵ prescribed rules for installment reporting by dealers in personal property, for sales of real property and nondealer personal property, and for dispositions of installment obligations. Under the Act, the rules for sales of real property and nondealer

⁴ S. REP. NO. 1000, 96th Cong., 2d Sess. 2 (1980).

⁵ Hereinafter all references are to the Internal Revenue Code as amended by the Installment Sales Revision Act of 1980 (P.L. 96-471), signed by President Carter Oct. 19, 1980.

sales of personal property are contained in amended Section 453, the rules for sales by dealers in personal property are contained in new Section 453A, and the rules applicable to dispositions of installment obligations are contained in new Section 453B.

Procedural Provisions of the Act

1. ELECTION OF INSTALLMENT REPORTING

Generally, the Service's requirement that an election to report a gain on the installment method be made in the tax return as filed or in an amended return, provided no position inconsistent with the installment election was taken in the original return,⁶ presented no problem for the well-advised taxpayer. Others, who were not so well advised, often failed to make this election or made a deficient election, especially when no payment was received in the year of sale. To simplify this situation for the future, the Act eliminates the requirement that the installment method must be elected for reporting gains from sales of realty and nondealer sales of personal property.⁷ Instead, the Act provides that the installment method will apply automatically to all qualified sales unless a taxpayer elects not to have the provisions apply with respect to such a sale.⁸

The election out procedure affords taxpayers the opportunity to recognize the entire gain currently in order to utilize loss carry-overs and in other situations where an increase in current income may be advantageous, *e.g.*, avoidance of the investment tax credit limitation or charitable contribution limitations. Current gain recognition on a deferred payment sale is also appropriate where the seller is a non-resident alien at the time of the sale and thereafter becomes a resident alien so that collections on the obligation(s) would give rise to gain recognition in the later year under an automatic installment method provision.

The statute, as enacted, does not specify the procedures for electing out. However, new Section 453(d)(2) provides that the regulations will prescribe the manner in which the election out must be made and that, except as provided by regulations, the election will be required to be made on or before the due date (including extensions of time for filing) of the income tax return for the year in which the sale occurs. Furthermore, the Senate Finance Committee Report⁹ states that:

It is anticipated that reporting the entire gain in gross income for the taxable year in which the sale occurs will operate as

⁶ See Rev. Rul. 65-297, 1965-2 C.B. 152. *But see Robert F. Koch*, 37 T.C.M. 1167 (1978), where the Service successfully argued that the taxpayer was precluded from electing the installment method where he had recognized the entire gain on a timely filed return, citing *Pacific National Co. v. Welch*, 304 U.S. 191 (1938).

⁷ I.R.C. § 453(a).

⁸ I.R.C. § 453(d).

⁹ S. REP. NO. 1000, *supra* note 4, at 12.

an election not to have installment sale reporting apply. It is anticipated that, under regulations, late elections will be permitted in rare circumstances when the Internal Revenue Service finds that reasonable cause for failing to make a timely election exists under the particular circumstances of each case.

Generally, an election made under this provision is to be irrevocable. However, an election may be revoked with the consent of the Internal Revenue Service. Generally, it is anticipated that consent would be given by the Internal Revenue Service in circumstances when a revocation does not have as one of its purposes the avoidance of income taxes. Also it is anticipated that consent to revocation will generally be granted in cases involving a contingent selling price if the election is made prior to adoption of final regulations under the provisions of the [Act] relating to contingent selling price sales and the request for revocation is filed within a reasonable time after the regulations are adopted.

Although no assurance can be given that the regulations will incorporate all of the aforementioned rules, the probability of the regulations reflecting these statements of congressional intent is very high. Accordingly, it would appear that the election out procedure will be irrevocable, except in the rarest of cases. However, until the regulations concerning the treatment of contingent sales (discussed later) are issued in final form, the election out procedure will be revocable.

Although the automatic election of installment reporting appears to be advantageous from a simplification standpoint, the result may be a greater burden on practitioners to forecast future events. Suppose a recently-formed corporation enters into a qualified installment sale for 10 years with the majority of the sales proceeds to be received and the gain to be recognized in the 9th and 10th years. Assume further that the corporation does not elect out and in year two it incurs a large net operating loss. Based upon the Senate Finance Committee Report, the corporation would not be able to elect out of installment reporting in year two and since the loss would expire before the majority of the gain is recognized, the loss carryover may never be utilized. Although this situation may be somewhat unlikely, care should be exercised in structuring installment sales and in foregoing the opportunity to elect out.

2. INITIAL PAYMENT LIMITATION

Under prior law, gain from the sale of realty or nondealer personal property could not be reported under the installment method if the payments received in the taxable year of sale exceeded 30 percent of the selling price. Under the Act, the 30 percent initial payment limita-

tion for reporting gain on the installment method for these two types of sales is eliminated.¹⁰

Although the 30 percent limitation was initially adopted to restrict the use of the installment method to transactions where hardship might result from the current imposition of tax, the restriction became overly complicated, and has often been referred to as merely a "trap for the unwary".

In applying the 30 percent initial payment requirement, confusion and often litigation stemmed from the question of what constituted payments in the year of sale and the definition of selling price. For instance, where the purchaser and seller failed to provide for interest in the sales agreement, the imputed interest rules of Section 483 reduced the selling price for the unstated interest, and as a result the 30 percent initial payment limitation may have been exceeded,¹¹ often to the surprise of the seller. Accordingly, the unsophisticated seller may have been in the position of reporting the entire gain in the year of sale without having the cash to pay the resulting tax.

Another problem which often arose as a result of the 30 percent initial payment limitation involved the sale of property subject to an existing mortgage which was assumed by the buyer. The amount of the mortgage assumed or to which the property is taken subject, is treated as part of the selling price but is not included in the contract price or the payments in the year of sale or any subsequent year. However, if the outstanding balance of the mortgage exceeded the seller's basis in the property, the excess constituted a payment in the year of sale and was included in the contract amount. As a result, many sellers failed to consider the "excess" of the mortgage over their basis in computing the 30 percent requirement and were thus unable to utilize the installment reporting method. In contrast, the sophisticated taxpayer often was able to avoid this result through the use of a "wraparound" mortgage.¹²

A problem related to that of the mortgage assumption was the treatment of selling expenses in determining whether the mortgage exceeded the basis of the property sold. Under Treasury Regs. Section 1.453-1(b), commissions and selling expenses are taken into account as an offset to selling price for purposes of determining the gross profit from a sale by a nondealer. They do not, however, reduce the amount of the payments, the total contract price, or the selling price per Treasury

¹⁰ I.R.C. § 453(b)(1) defines the term "installment sale" as a disposition of property where at least 1 payment is to be received after the close of the year in which the disposition occurs. I.R.C. § 453(b)(2) excludes from the definition, dealer dispositions of personal property and dispositions of inventories. No limitation exists with respect to initial payments, two payments, or minimum sale price.

¹¹ See Reg. § 1.453-1(b)(2).

¹² See Reg. § 1.453-4(c). See also *Burnet v. S&L Building Corp.*, 288 U.S. 406 (1933); *Stonecrest Corporation*, 24 TC 659 (1955), *non-acq.*, 1956-1 C.B. 6; *Stephen A. Asler, Jr.*, 39 T.C. 458 (1962); *Floyd R. Clodfelter*, 48 TC 694 (1967), *aff'd*, 426 F. 2d 1391 (9th Cir. 1970). See Ginsburg, "Taxing the Sale for Future Payments", 30 Tax Law Review 469, 488 (1975).

Regs. Section 1.453-4(c). However, according to the Ninth Circuit,¹³ selling expenses are added to the basis of the property sold. The differing results under these opposing views can have a substantial impact on the 30 percent test and have led to unnecessary confusion.

One last area of confusion was the Internal Revenue Service's position with respect to the buyer's payments on outstanding indebtedness during the year of sale. The Service's position has been that in the case of a casual sale of personal property, the assumption and payment of secured and general unsecured liabilities by the purchaser will not be considered as a payment in the year of sale, if the seller established that the liabilities were incurred in the ordinary course of business and not for purposes of avoiding the 30 percent initial payment limitation.¹⁴ This established a subjective test which further complicated the administration of the 30 percent rule and the installment sale rules in general.

The elimination of the 30 percent limitation not only remedies the above described problems, but fosters an economic boost to future sales. No longer must a sale be structured in a manner to assure the seller of the opportunity to report the gain on the installment method. Now, the seller is able to receive a larger down payment without being taxed on the entire gain. The seller no longer must remain liable on a mortgage after the property has been sold under a wraparound mortgage, and no longer must a maze of computations be made in order to assure a seller that the 30 percent limitation has not been violated.

3. SELLING PRICE LIMITATION

The Act eliminates the \$1,000 minimum selling price requirement for casual sales of personal property that was present under old Sec. 453 (b)(1)(B). As noted earlier, the original proposals would have raised the \$1,000 threshold limitation to \$3,000. The reason advanced for the increase was the elimination of many small transactions from the scope of the installment sale provisions, thereby eliminating much of the paperwork associated with the use of the installment sales method of reporting. It was noted by various witnesses that increasing the limitation would only complicate the administration of the installment sales provision and, in addition, would result in another trap for the unwary. Indeed, it was noted that in all likelihood a sale of this size would be undertaken only by a lower-bracket taxpayer who would not report the gain until cash was received in any event and, thus, an increased floor would further complicate the administrative procedure.

It was recommended by the AICPA and others that the floor be eliminated altogether, thereby doing away with the need for the Internal Revenue Service to concern itself with whether or not the transaction violated a \$1,000 or \$3,000 floor. Furthermore, it was noted that, if

¹³ *Kirschenmann v. U.S.*, 488 F. 2d 270 (9th Cir. 1973). *But cf.* Rev. Rul. 74-384, 1974-2 C.B. 152; Rev. Rul. 74-351, 1974-2 C.B. 144; *Seletha O. Thompson*, 9 BTA 1342 (1928), *acq.*, VII-2 C.B. 39.

¹⁴ Rev. Rul. 73-555, 1973-2 C.B. 159.

the proposal to reverse the installment election were adopted, the elimination of the floor amount was almost mandatory, since such sales would qualify automatically, unless a threshold limit were violated. Thus, retaining a threshold limit would lead to further complications.

Accordingly, the floor amount for casual sales of personal property has been eliminated.¹⁵

4. TWO-PAYMENT RULE

Under prior law, the Internal Revenue Service took the position, and courts had agreed,¹⁶ that, under Section 453(b), a taxpayer could *not* elect to report income from the sale of real property or casual sales of personal property on the installment method where the total purchase price was payable as a single sum in a year subsequent to the year of sale. The Act eliminates the formalistic requirement that a sales agreement must provide for two or more payments to qualify for installment reporting.¹⁷

The illogic of the prior law can be seen in the following examples:

Example 1: T sells real estate to P for \$10,000, under the following terms, \$1 down payment in the year of sale, and \$9,999 in 10 years.

Example 2: T sells real estate to P for \$10,000 under the following terms, no down payment in the year of sale, and \$10,000 due in 10 years.

Under prior law, in Example 1, T could report his sale on the installment method and would report almost all of the gain in the 10th year. On the other hand, in Example 2, T would be required to report the entire gain in the first year, since only one payment was contemplated. Here again, the prior-law rule provided a trap for the unwary which could not be justified. Accordingly, the two or more payment rule was eliminated.

Substantive Provisions of the Act

The provisions discussed to this point were largely procedural in nature. However, the Installment Sales Revision Act of 1980 also contains provisions which are substantive in nature. These were incorporated in the Act to reduce the level of uncertainties under prior law and to better rationalize the tax treatment of deferred payment sales.

5. RELATED PARTY SALES

Of all the provisions contained in the Act, the related party sales rules received the most attention. Under the original bills, installment treatment would have been denied on the sale of property directly or

¹⁵ I.R.C. § 453(b), *supra* note 10.

¹⁶ See Rev. Rul. 69-462, 1969-2 C.B. 107, *amplified* by Rev. Rul. 71-595, 1971-2 C.B. 223; *Baltimore Baseball Club, Inc. v. U.S.*, 481 F. 2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 T.C. 593 (1971), *nonacq.*, 1972-2 C.B. 4.

¹⁷ I.R.C. § 453(b), *supra* note 10.

indirectly to a related person, as defined in Sections 267(b) and 707(b)(1). The purpose of this provision was to curtail what was considered to be an abuse of prior law. An example of such an abuse is as follows:

S owns stock in a closely-held corporation. The basis of such stock to S is \$50,000. S receives an offer from B to purchase his stock for \$5,000,000. S does not accept B's offer, but instead establishes a trust for the benefit of minor children and sells the stock to the trust for \$5 million and takes back a 20-year note bearing interest at 6%. S elects to report the gain on the installment method, thus deferring recognition of the gain over the term of the note. The next day the trust sells the stock to B for \$5 million cash and realizes no gain. The trust then invests the proceeds for the benefit of S's children.

In the leading case in this area, *W. B. Rushing v. Comm'r.*,¹⁸ the court established the test that in order to receive the benefit of the installment method, the "seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." It is interesting to note that in *Rushing* the seller sold corporate stock to a trust for the benefit of his children after the corporation had adopted a plan of liquidation under which the shareholders would have received an installment obligation from an unrelated purchaser of the corporation's assets. However, since the distribution of an installment obligation would have triggered recognition of the entire gain to the shareholders, to avoid current taxation it was necessary to enter into the transaction described. The Commissioner challenged the transaction on the basis of the assignment of income theory, but the court rejected that theory and established the "control or enjoyment test" stated above.

In a similar case subsequent to *Rushing*, a plan of liquidation was adopted following the sale of the corporate stock although the sale of the corporation's assets had been tentatively negotiated.¹⁹ In *Pityo*,²⁰ the taxpayer's wife was the beneficiary and a bank was the independent trustee. In *Roberts*,²¹ a case involving the sale of readily tradable stock, the trustees were the taxpayer's brother and personal accountant, however, the Tax Court still upheld the validity of the transactions based upon the *Rushing* control or enjoyment test. In *Goodman*,²² the sale of apartments by the trusts occurred one day after acquisition from the grantors who were also the trustees of the trusts. The initial sale was structured in this manner because a direct "cash sale was not attractive because of the income tax liability. . . ." In an earlier holding, *Nye*,²³ the taxpayer was permitted to use the installment method for reporting

¹⁸ *Rushing v. Comm'r.*, 441 F. 2d 593 (5th Cir. 1971), *aff'g* 52 T.C. 888 (1969).

¹⁹ *Carl E. Weaver*, 71 T.C. 443 (1978).

²⁰ *William D. Pityo*, 70 T.C. 225 (1978).

²¹ *Clair E. Roberts*, 71 T.C. 311 (1978).

²² *William J. Goodman*, 74 T.C. No. 53 (7/16/80).

²³ *Nye v. U.S.*, 407 F. Supp. 1345 (M.D.N.C. 1975).

gain on the sale of marketable securities to her husband even though he immediately thereafter sold the securities. In the few recent cases where the Service has been successful,²⁴ the government's argument against the use of the installment method was upheld because no bona fide purpose existed for the transaction other than the avoidance of tax.

Acknowledging the tax avoidance technique which stemmed from the above case law, Senator Long introduced S. 1063 which would have disallowed the use of the installment method for most related party transactions. The immediate reaction to the proposal was that it was a Draconian solution to the problem. First, it was viewed as placing the emphasis on the initial sale and not on the resale where the abuse really existed. In addition, it was felt that the use of Sections 267(b) and 707(b) to define related parties was too broad and that the definition of a related party contained in Section 318, with certain modifications, was more equitable. Lastly, it was believed that the tax treatment afforded to installment sales of depreciable property and other property should differ, since the former could cause distortion merely due to the increased depreciable basis of the property.

General Related Party Rules. Under the Act, in the case of an installment sale, *i.e.*, the "first disposition", of nondepreciable property made after May 14, 1980, an untimely disposition by the related party purchaser will trigger the recognition of gain by the initial seller, based on the initial seller's gross profit ratio, to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale prior to the end of the taxable year of the second disposition.²⁵ Under this rule, gain recognition to the initial seller will be accelerated to the extent that additional cash and other property is received by the related-party group as a whole. (It should be noted, however, that the triggering under a second disposition occurs based on the amount "realized" rather than the amount of additional cash or other property received on the second disposition. Thus, for example, if the triggering resale is on an installment basis, unless the exception of new Section 453(e)(7) applies, there may be an acceleration of the initial deferred gain before the group has acquired cash or other property.)

If the property is transferred other than in a sale or exchange, the measure of the amount treated as realized is the fair market value of the property disposed of.²⁶ The Senate Finance Committee Report indicates that, to the extent that the amount realized on the second sale is attributable to improvements made by the related party purchaser, such amount will not be attributed to the initial seller.²⁷

The foregoing rules may be illustrated by the following example:

²⁴ *Paul G. Lustgarten*, 71 T.C. 303 (1978); *Phillip W. Wrenn*, 67 T.C. 576 (1976).

²⁵ I.R.C. § 453(e)(1) and (3).

²⁶ I.R.C. § 453(e)(4).

²⁷ S. REP. NO. 1000, *supra* note 4, at 15.

Father sells 4 acres of unimproved land with a basis of \$40,000 to Son for \$80,000 and takes back an installment note for the full purchase price. In the following year, Son sells one acre to X, an unrelated individual, for \$28,000 in cash. On a second acre of land, Son builds a house at a cost of \$70,000 which he sells to Z, an unrelated individual, for \$112,000. Of the total selling price of \$112,000, \$90,000 is attributable to improvements made by Son.

With respect to the one acre resold by the Son to X, the Fathers must include \$28,000 as the amount realized on the installment sale to Son, and he recognizes a \$14,000 gain (\$28,000 x 50% gross profit percentage.)

On the sale of the second acre with improvements, Father realizes only \$22,000. The remaining \$90,000 relates to improvements by the Son.

It should be noted that, if Father had sold the 4 acres of land separately and received 4 installment notes of \$20,000 each, on the sale of the first acre to X, he would have realized only \$20,000 on the Son's disposition.

Even if Son had received an installment note on the sale of the first acre, the entire amount realized would be treated as received by the Father unless the non-tax avoidance exception of new Section 453(e)(7) applies. This is a result which is harsher than the Service's prior litigating position.²⁸

In the above example, if the Son makes subsequent payments to the Father, the Act provides that the Father will not be treated as receiving payment on the sale until the aggregate of such payments exceeds the amount deemed received under the general related party rule of new Sec. 453(e)(1).²⁹

What Is an Untimely Second Disposition? The above rule only applies to dispositions which occur within two years of the initial sale.³⁰ However, the two year period is suspended during any period that the risk of loss with respect to the property is diminished. The risk of loss with respect to the property is diminished where the related party purchaser holds a put with respect to the property (or similar property); another person holds an option to acquire the property, unless the option price is the fair market value at the time of exercise; or the related party enters into a short sale or any other transaction which has the effect of substantially reducing the initial purchaser's risk of loss.³¹ However, a typical cross-purchase arrangement of a closely-held corporation is not to be considered as substantially diminishing the risk of loss.³²

For marketable securities no time limit applies. In other words, if

²⁸ See *Goodman*, *supra* note 22.

²⁹ I.R.C. § 453(e)(5).

³⁰ I.R.C. § 453(e)(2)(A).

³¹ I.R.C. § 453(e)(2)(B).

³² S. REP. NO. 1000, *supra* note 4, at 15.

marketable securities are sold to a related party purchaser on an installment basis, any subsequent resale will trigger gain on the first sale. For purposes of this provision, a "marketable security" means any security for which there was a market on an established securities market or otherwise.³³

"Related Party" Defined. For purposes of applying the related party rules, a "related person" means a person whose stock would be attributed under Section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property.³⁴ Paragraph (4) of Section 318(a) relates to ownership by reason of options. By adopting Section 318(a) as the standard for defining a related party, spouses, children, grandchildren and parents were included but brothers and sisters were excluded, thus removing an objection initially raised to the use of Sections 267(b) and 707(b) as the determinative sections for defining related parties.

Related Party Sale Exceptions. There are three notable exceptions to the related party rules. First, the related party rules will not apply where the second disposition of the property occurs as a result of an involuntary conversion.³⁵ Second, the rules will not apply where the initial seller or purchaser has died.³⁶ The Senate Finance Committee Report indicates that this rule will apply upon the death of either spouse where the installment obligation or the property was held jointly or as community property.³⁷ However, the most significant exception to the related party rules, permits the taxpayer to establish to the satisfaction of the Service that none of the dispositions had as one of their principal purposes the avoidance of Federal income taxes.³⁸ The Senate Finance Committee Report indicates that regulations should be issued establishing "definitive guidelines" for applying this latter exception. The Report also states that it is anticipated the regulations will permit second dispositions which normally are tax free, *e.g.*, charitable transfers, like-kind exchanges, and transfers to controlled corporations or partnerships. In addition, other types of involuntary second dispositions will be within the exception, *e.g.*, a foreclosure action. The last exception also may be applied where the second disposition is also an installment sale with terms which are substantially equivalent to, or longer than, those of the initial sale.³⁹

In addition to the above exceptions, the Act provides that where the first sale is of stock to the issuing corporation, the related party rules will not apply.⁴⁰

For purposes of the related party rules, the Act extends the period for assessing a deficiency with respect to a first disposition for 2 years

³³ I.R.C. § 453(f)(2).

³⁴ I.R.C. § 453(f)(1).

³⁵ I.R.C. § 453(e)(6)(B).

³⁶ I.R.C. § 453(e)(6)(C).

³⁷ S. REP. NO. 1000, *supra* note 4, at 16.

³⁸ I.R.C. § 453(e)(7).

³⁹ S. REP. NO. 1000, *supra* note 4, at 16.

⁴⁰ I.R.C. § 453(e)(6)(A).

after the date on which the person making the first disposition furnishes a notice to the IRS that there was a second disposition of the property.⁴¹

Related Party Rules for Installment Sales of Depreciable Property. A separate and more stringent rule was adopted for certain related party sales of *depreciable* property. The clear purpose of the rule is to prevent a seller from deferring the recognition of the gain, while the related party purchaser depreciates the property having a stepped-up basis. Accordingly, the Act provides that all payments to be received on the installment obligations will be deemed to be received in the year of sale,⁴² thus, placing such sellers effectively on the accrual method with respect to the sale of depreciable property not subject to an installment election. Once again, however, the Act provides an exception to the rule where the taxpayer can establish to the satisfaction of the Service that the disposition did not have as one of its principal purposes the avoidance of Federal income tax.⁴³

For purposes of the related party rules concerning depreciable property, a "related party" is defined by reference to Section 1239(b) as amended by the Act.⁴⁴ Accordingly, for this purpose only a taxpayer and a taxpayer's spouse, a taxpayer and a taxpayer's 80 percent-or-more owned entity, or two 80-percent-or-more owned entities are considered related parties. Section 1239(c) defines an 80 percent owned entity as a corporation in which the taxpayer owns (directly or indirectly) 80 percent or more in value of the outstanding stock, or a partnership in which the taxpayer owns (directly or indirectly) an 80 percent or more interest in the capital or profits of the partnership. For purposes of determining the aforementioned ownership, the principles of Section 318 will apply, except that, the members of the individual's family will consist only of the individual and such individual's spouse, and the entity attribution rules will be applied without regard to the percentage of ownership limitations.

The purpose of changing the definition of a related party under Section 1239(b) was to apply the recharacterization of gain rules of Section 1239 to sales of depreciable property between a very restrictive class of closely-related parties. It was also considered desirable to draw on the revised relationship for purposes of the more stringent related party rules for deferred payment sales.

However, in drafting new Section 1239(b), the Senate Finance Committee version of the bill changed the basic terminology of the provision from sales between an "individual" and described related parties, to sales between a "taxpayer" and those related parties. As a result, the scope of the provision includes not only the above described situations, but also sales of depreciable property between a publicly-held company and its subsidiary or a corporation controlled by any of its shareholders.

⁴¹ I.R.C. § 453(e)(8).

⁴² I.R.C. § 453(g)(1).

⁴³ I.R.C. § 453(g)(2).

⁴⁴ Installment Sales Revision Act of 1980, Pub. L. No. 96-471, § 5, 94 Stat. 2255.

Based on the legislative history of this provision, this result clearly was not intended and one can only anticipate that the provision will be amended to remedy the unintended results. In the interim, it is anticipated that the "no tax avoidance" provision of new Sec. 453(g)(2) will be utilized by the IRS to avoid the accrual basis problem in appropriate deferred payment sale cases. Unfortunately, no statutory basis exists for avoiding the gain recharacterization rule of Sec. 1239.

6. SALES SUBJECT TO A CONTINGENCY

One of the areas which had created considerable controversy under prior law involved a deferred payment sale where the selling price was wholly or partly contingent. Under prior case decisions, it had been established that the installment sales provisions required a fixed and determinable selling price at the time of the sale.⁴⁵ In recognition of this problem, taxpayers often sought to use the cost-recovery method of reporting the gain on such open-ended transactions.⁴⁶ The Act changes this result and permits installment sale reporting for sales which include a contingent element for all or part of the contract price.⁴⁷ New Sec. 453(i)(2) simply calls for regulations to be prescribed providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

The Senate Finance Committee Report provides the following guidelines for the drafting of such regulations where the gross profit or total contract price cannot be computed.⁴⁸ Basically, for sales where a maximum selling price exists, the regulations are to provide for basis recovery based on a gross profit ratio determined by reference to the maximum selling price. The maximum sales price will be determined assuming that all contingencies, formulas, etc., operate in favor of the taxpayer. Should it subsequently be determined that a contingency will not be satisfied in whole or in part, the taxpayer's income from the sale will then be recomputed. If the taxpayer has reported more income in prior taxable years than the total recomputed income, the excess will be deductible in the year of adjustment as a loss.

In the case where no maximum selling price can be determined, but the obligation is payable over a fixed period of time, the basis of the property sold will be recovered ratably over the fixed period provided in the contract. Where both the sales price and the payment period are indefinite, but a sale has occurred, the Report states that the regulations should permit ratable basis recovery over some reasonable period of time. In addition, the Report notes that in appropriate cases, it is intended that basis recovery will be permitted under an income forecast

⁴⁵ See, e.g., *Gralapp v. U.S.*, 458 F. 2d 1158 (10th Cir. 1972); *In re Steen*, 509 F. 2d 1398 (9th Cir. 1975). But cf., *National Farmers Union Service Corp. v. U.S.*, 67-1 USTC ¶ 9234 (D. Colo. 1967), *aff'd on other grounds*, 400 F. 2d 483 (10th Cir. 1968).

⁴⁶ See, e.g., *Burnet v. Logan*, 283 U.S. 404 (1931).

⁴⁷ I.R.C. § 453(i)(2).

⁴⁸ S. REP. NO. 1000, *supra* note 4, at 23-24.

type method. Generally, an income forecast method will be appropriate where it is demonstrated that receipts will be greater for the earlier years of the payment period and then decline in the later years. This rule should apply even if the sales contract provides for payments over a fixed period of time.

With the expansion of the types of sales eligible for installment reporting, it is anticipated that the cost-recovery method of *Burnet v. Logan* will not be available whenever a fixed sales price exists and the use of such method will be available only in rare and extraordinary cases involving contingent sales prices.

The various types of contingent payment sale transactions which could be covered by the regulations are too numerous to be covered in this article. It is anticipated that the regulations will contain extensive examples and will undergo close scrutiny before their final adoption. The following examples demonstrate what can be expected based on the Senate Finance Committee Report:

Example 1: Maximum Sales Price—X sells stock, with an adjusted basis of \$5,000, for annual contingent payments based upon a percentage of taxable income of the corporation, with a stated maximum sales price, exclusive of interest, of \$50,000. The annual payments will be increased for interest at an adequate rate. Since X's basis for the stock is 10 percent of the maximum sales price, 10 percent of each annual payment will be treated as a recovery of basis, and the remainder will be included in income. At some later time, should it be determined that the full \$50,000 will not be paid, an adjustment will be permitted at that time.

Example 2: Fixed Time Period—Same as Example 1, except X is to receive payments equal to 10% of the corporation's net income after taxes for 5 years. The payments will be adjusted for interest at an adequate rate. Based upon the terms of the contract, X's basis for the stock should be recovered at the rate of 20 percent per year. If, in any of the first four years of the contract, the payment received is less than \$1,000 (20 percent x \$5,000 basis), no loss will be recognized, but the amount of such unrecouped basis would be deferred to the following year. In the fifth year, if X has not fully recovered basis, a loss would be recognized.

Example 3: Maximum Sales Price and Fixed Time Period—Same as Example 1, except that the payments will be made only for 5 years as in Example 2. It is anticipated that the regulations will require the maximum sales price to be used to compute the gross profit percentage and the result will be the same as in Example 1.

As noted, many other possibilities exist, but they should be the subject of more detailed study and analysis.

7. THIRD PARTY GUARANTEES

During the time the Act was being considered, the use of standby letters of credit to secure deferred payment obligations and their effect on the installment method of reporting became an issue as a result of recent court decisions. Under prior law, payments taken into account in the year of sale did not include the purchaser's note or future promise to pay, unless the obligation was a bond or other evidence of indebtedness payable on demand or which was readily tradable. However, in a recent Tax Court case, *Griffith*,⁴⁹ it was held that the taxpayer had received full payment in the year of sale, since the purchaser's obligation was secured by a standby letter of credit. However, in a Tenth Circuit case⁵⁰ it was held that a note secured by a letter of credit did not constitute payment.

In similar cases involving the use of escrow accounts to secure installment obligations, the position of the courts is mixed. For example, in *J. Earl Oden*,⁵¹ the seller sold property in exchange for cash (less than 30% of the total sales price) and a note payable in three annual installments. The note was secured by certificates of deposit placed in escrow with a bank. The Court concluded that the seller had the right to the certificates of deposit and that the full sales price was received in the year of sale. The Court found that the payments were actually made from the escrow funds so that the seller actually looked to the escrow account rather than to the buyer. By contrast, in *C. J. Porterfield*,⁵² the intent of the parties was controlling. The Court held that the parties to the sale intended the escrow account to be security only and, therefore, the creation of the escrow account did not constitute a payment in the year of sale.

Clearly, the use of security devices such as escrows, letters of credit, or other guarantees by third parties to secure payment of installment notes has been a troublesome area. Under the Act, a third party guarantee (including a standby letter of credit) is not to be taken into account in determining if the buyer's evidence of indebtedness constitutes payment to the seller.⁵³ For this purpose, a guarantee which is not treated as payment would not include a third party note or any other type of third party obligation which is transferable or marketable prior to default in payment by the installment purchaser.⁵⁴

8. INSTALLMENT OBLIGATIONS DISTRIBUTED IN A 12-MONTH CORPORATE LIQUIDATION

Under prior law, a shareholder was denied installment sale treatment when a corporation adopted a plan of complete liquidation under Sec-

⁴⁹ *J. K. Griffith*, 73 T.C. 933 (1980), *appeal docketed* (5th Cir. 5/19/80).

⁵⁰ *Sprague v. U.S.*, 80-2 U.S.T.C. ¶ 9521 (10th Cir. 1980), *rev'g* 78-2 U.S.T.C. ¶ 9650 (W.D. Okla. 1978).

⁵¹ *J. Earl Oden*, 56 T.C. 569 (1971).

⁵² *C. J. Porterfield*, 73 T.C. 91 (1979).

⁵³ I.R.C. § 453(f)(3).

⁵⁴ S. REP. NO. 1000, *supra* note 4, at 18-19.

tion 337, sold its property for installment notes, and distributed those notes to the shareholders. While a special rule generally protected the corporation from gain recognition upon the distribution of an installment obligation, prior law required the shareholders to take the fair market value of the notes into account for purposes of determining the currently taxable gain on the liquidation. As noted earlier, this current recognition treatment was the reason the taxpayer in *Rushing*⁵⁵ structured the sale of his corporate stock to a trust, thus leading to much litigation concerning related party sales.

The Act permits the deferral of gain recognition when a shareholder receives an installment obligation, which was received by the corporation from the sale of its assets in the 12-month period prescribed under Section 337(a), in a taxable corporate liquidation. The shareholder who receives the installment obligation will be entitled to report the gain on liquidation under the installment method as payments are received on the installment obligation.⁵⁶ This provision applies to distributions of obligations after March 31, 1980.

If liquidating distributions are received in two taxable years of the shareholder, gain reported on the liquidation in year one will have to be recomputed by use of an amended return. The Senate Finance Committee Report contains the following example demonstrating the operation of the new rules:⁵⁷

Assume that the taxpayer is the sole shareholder of a corporation with an adjusted basis of \$200,000 in the stock (all of the stock having been acquired in the same transaction at the same cost), and is a calendar year taxpayer. Also, assume that the corporation adopts a plan of liquidation in July, 1982, that the corporation sells all of its assets in August, 1982 to an unrelated purchaser for \$1 million, consisting of \$250,000 in cash and an installment note for \$750,000, that the entire gain qualifies for nonrecognition under Section 337, that there is no imputed interest income or original issue discount, that the corporation distributes the cash in November, 1982, and that the note is distributed in complete liquidation in June, 1983. The taxpayer would initially report a gain of \$50,000 in 1982 (\$250,000 cash received less \$200,000 basis in the stock).

After the distribution of the note in 1983, under the installment method, the taxpayer would recompute the gain reported in 1982 by allocating basis according to the installment sales rules. Thus, 75 percent (\$750,000 (face amount of installment obligation) divided by \$1 million (total distribution)) of the taxpayer's basis in the stock, or \$150,000

⁵⁵ *Rushing*, *supra* note 18.

⁵⁶ I.R.C. § 453(h).

⁵⁷ S. REP. NO. 1000, *supra* note 4, at 21-22.

(75 percent times \$200,000) would be allocated to the installment obligation. Further, 25 percent (\$250,000 divided by \$1 million) of the taxpayer's basis in the stock, or \$50,000 (25 percent times \$200,000) is allocated to the distribution of the cash. The taxpayer thus is required to file an amended return for 1982 to reflect an additional \$150,000 of gain (cash received of \$250,000 less the sum of \$50,000 basis and \$50,000 gain initially reported). Eighty percent of each payment on the note (other than interest) must be reported as gain by the taxpayer (gain of \$600,000 (\$750,000 face amount of obligation less basis of \$150,000) divided by \$750,000 (contract price)).

The Act interrelates the provisions of the liquidation rule with those of the related party rules by denying the special deferral treatment to the extent that the obligation is attributable to the sale of depreciable property to a related party (of the shareholder) described in Section 1239(b). Furthermore, if a party described in new Section 453(f)(1), *i.e.*, a party described in Section 318(a) (without the application of paragraph 4 thereof), purchases the corporate assets and then disposes of them, the related party disposition rules will apply to the related shareholder receiving the installment obligation upon liquidation.

9. LIKE-KIND EXCHANGES AND NON-DIVIDEND "BOOT"

Prior to enactment of the Act, the law required,⁵⁸ and the IRS held in Rev. Rul. 65-155,⁵⁹ that the transfer of property for cash payments and like-kind property was eligible for both installment method reporting and nonrecognition treatment under Section 1031. The gain to be recognized under the installment method was the total gain realized less the gain deferred under the like-kind exchange provisions. However, the value of the like-kind property received was taken into account in determining the selling price, the contract price, and payments received for purposes of the installment sale rules.

In order to reflect the object of the installment sale provisions, *i.e.*, to permit taxpayers to recognize gain when cash or other taxable property is received, the Act provides that like-kind property as described in Section 1031(b) will not be treated as a payment for purposes of reporting income under the installment method.⁶⁰

The Act provides that, for purposes of computing the gain on an installment sale where like-kind property is also received, the gross profit will be the amount which would be recognized based upon the face value of the installment obligation. In computing the total contract price in a like-kind situation, the value of the like-kind property will

⁵⁸ See, *Clinton H. Mitchell*, 42 T.C. 953 (1964), *acq.* 1965-2 C.B. 6; *Albert W. Turner*, 540 F. 2d 1249 (4th Cir. 1976); *C. W. Yeager*, 18 T.C.M. 192 (1959).

⁵⁹ Rev. Rul. 65-155, 1965-1 C.B. 356.

⁶⁰ I.R.C. § 453(f)(6).

not be included in the computation. Instead, the total contract price will consist of the sum of the money and the fair market value of other property received, plus the face amount of the installment obligation.

The basis of the like-kind property received will be determined as if the installment obligation had been satisfied at its face amount. Thus, the transferor-seller's basis in the like-kind property transferred in the exchange will be first allocated to the like-kind property received, but not in excess of the property's fair market value, and the remaining basis will be used to compute the gross profit ratio for purposes of recognizing the gain on the installment sale.

An example of the operation of both the new and old provisions as contained in the Senate Finance Committee Report follows:⁶¹

Assume that the taxpayer exchanges property with a basis of \$400,000 for like-kind property worth \$200,000, and an installment obligation for \$800,000 with \$100,000 payable in the taxable year of the sale and the balance payable in the succeeding taxable year.

	<i>Rev. Rul. 65-155— Like kind property taken into account</i>	<i>Like kind property not taken into account</i>
Contract price	\$1,000,000	\$800,000
Gross profit	600,000	600,000
Gross profit ratio (percent)	<u>(60)</u>	<u>(75)</u>
Gain to be reported for:		
1. Taxable year of sale:		
(a) 60% of \$300,000 (payments "received" of \$100,000 cash and \$200,000 value of like-kind property)	180,000	
(b) 75% of \$100,000 (cash payments)		75,000
2. Succeeding taxable year:		
(a) 60% of \$700,000 (cash received)	420,000	
(b) 75% of \$700,000 (cash received)		525,000
Total gain recognized	<u>600,000</u>	<u>600,000</u>
3. Basis of like-kind property received . . .	200,000	200,000

When boot under Section 356(a)(1) was received in a reorganization exchange, a result parallel to that in the like-kind exchange situation resulted. Accordingly, the Act provides that similar rules will apply

⁶¹ S. REP. NO. 1000, *supra* note 4, at 20.

to non-dividend Section 356 distributions which occur as part of a reorganization exchange.⁶²

10. CANCELLATION OF INSTALLMENT OBLIGATION

Pursuant to a decision of a District Court in *Miller v. Usry*,⁶³ taxpayers/sellers attempted to avoid the installment obligation disposition rules by cancelling the obligation rather than by making a direct gift which would have constituted a disposition and required the recognition of the gain. The technique was most often used among family related parties.

Under new Section 453(B)(f)(1) this gift-cancellation method will not be available. New Section 453(B)(f)(1) provides that a cancellation of an installment obligation will be treated as a disposition that is not a sale or exchange. If the obligor and the obligee are related parties, the Act provides that the amount taken into account as a disposition, thus triggering recognition of unreported gain attributable to the obligation, is not to be less than the face amount of the installment obligation.

11. TRANSFER OF INSTALLMENT OBLIGATIONS TO LIFE INSURANCE COMPANIES

A special rule of prior law, old Section 453(d)(5), provided that transfers of installment obligations to a life insurance company were not eligible for nonrecognition treatment as was generally accorded similar tax-free transfers. Under the general rule for tax-free transfers, no gain is recognized on the transfer of the installment obligation; however, the transferee simply succeeds to the basis of the seller and recognizes the remaining gain upon receipt of future payments. In order to provide equivalent treatment to tax-free transfers to life insurance companies, the Act provides that the general rule of nonrecognition will apply to such transfers, if the life insurance company elects to report any remaining gain as investment income under Section 804(b) as the installment payments are received.⁶⁴

12. BEQUEST OF INSTALLMENT OBLIGATION TO OBLIGOR

Pursuant to old Sections 453(d)(3) and 691(a)(4), the general rule requiring recognition of gain upon a disposition of an installment obligation did not apply to a bequest of the installment obligation at death. The unreported gain attributable to the installment obligation was treated as income in respect of a decedent, *i.e.*, the recipient was taxed on the receipt of installment payments and was entitled to a deduction for the estate taxes paid on the gain on the obligation not recognized prior to the decedent's death under Section 691(c). However, where the installment obligation was left to the obligor, no payments were

⁶² See the flush language of I.R.C. § 453(f)(6).

⁶³ *Miller v. Usry*, 160 F. Supp. 368 (W.D. La. 1958).

⁶⁴ I.R.C. § 453(B)(e)(2).

made since there was a merger of the obligor and obligee. In this situation, the obligor obtained a stepped-up basis for the property purchased without recognition of all or part of the gain for Federal income tax purposes.

To rectify the described situation, the Act amends Section 691(a) to provide that any unreported gain from an installment sale must be recognized by the decedent's estate, if the obligation is transferred by bequest, devise, or inheritance to the obligor or is cancelled by the executor.⁶⁵ For this purpose, under new Section 691(a)(5)(C), an installment obligation which becomes unenforceable will be treated as if it were cancelled. Unreported gain upon disposition to the obligor will be recognized by the estate, if the obligation was transferred at the decedent's death, or, if held by a person other than the decedent, *e.g.*, a revocable trust, at the decedent's death, the recognition of any gain will be by such other person.

In addition, the Act continues to treat related parties differently by providing that, if the decedent and the obligor are related persons (as defined in new Section 453(f)(1)), the fair market value of the installment obligation will be treated as not less than its face amount.⁶⁶

13. FORECLOSURE OF REAL PROPERTY

Section 1038 limits the recognition of gain that results from the reconveyance of real property to the installment seller in partial or full satisfaction of debt to the lesser of any unreported gain or the amount by which the sum of money and the fair market value of property received prior to the reacquisition exceeds the amount of gain previously reported. However, the IRS, in Rev. Rul. 69-83,⁶⁷ held that the general rule did not apply to a reconveyance of property to the estate of a deceased taxpayer who made the installment sale. Since this position was inconsistent with the treatment which would have been accorded the decedent had he lived, the Act provides that the estate or beneficiary of a deceased seller will be entitled to the same nonrecognition treatment upon the foreclosure of real property in full or partial satisfaction of a secured purchase money debt as the deceased seller would have received.

The basis of the property acquired will be the same as it would have been, had the property been reacquired by the original seller, increased by an amount equal to the Section 691(c) deduction for estate taxes which would have been allowable had the repossession been taxable.⁶⁸

14. ELECTION OF INSTALLMENT METHOD BY ACCRUAL METHOD DEALERS

Under Section 453(c) of prior law, an accrual method dealer in personal property who elected to change to the installment method had

⁶⁵ I.R.C. § 691(a)(5)(A).

⁶⁶ I.R.C. § 691(a)(5)(B).

⁶⁷ Rev. Rul. 69-83, 1969-1 C.B. 202.

⁶⁸ I.R.C. § 1038(g).

to include in income the gain attributable to the receipt of installment payments on sales made prior to the election to use the installment method, even though those sales previously had been included in taxable income. The taxpayer then was permitted an adjustment to tax to offset the double inclusion of income. However, under Section 453(c) as it existed, the dealer generally incurred more total tax than if the sale had been reported only once. To avoid the double-inclusion problem, most dealers "sold" all of their installment receivables to an unrelated party (e.g., a commercial bank) or transferred them to a subsidiary corporation before the close of their last accrual method year.

To remedy this situation and eliminate the need for artificial transactions by dealers who adopt the installment method, the Act repealed Section 453(c) which provided the offset tax credit, and as a conforming measure repealed Section 481(d) which had excluded a dealer's election of the installment method from the general rules of Section 481. The intent of the Act was to permit dealers who elect the installment method of reporting under new Section 453A(a)(1), to report gain as payments are received for installment sales made in taxable years ending after the date of enactment and to avoid the double inclusion required under prior law for payments received in the same, or a later, taxable year on installment sales made in prior years, *i.e.*, a clean cut-off approach was intended.⁶⁹

However, as a result of the different effective dates which apply to the repeal of old Sections 453(c) and 481(d) and to the enactment of new Section 453A, the intent of the provision was not artfully achieved. The effective date for the repeal of old Sections 453(c) and 481(d) is for dispositions made after the date of enactment, October 19, 1980. The effective date for new Section 453A is taxable years ending after the date of enactment. Although not entirely clear, it would appear that old Sections 453(c) and 481(d) could apply to payments received on installment sales entered into prior to October 20, 1980, even though new Section 453A applies. Thus, if a dealer elects the installment method for calendar year 1980, any payments received that year on installment sales made prior to October 20, 1980, including sales which were reported in income for 1979, literally could be required to be included again in 1980, and a credit would be permitted under old Section 453(c).

The solution for this situation is to have the effective dates for the repeal of old Sections 453(c) and 481(d) coincide with the effective date of new Section 453A, *i.e.*, taxable years ending after October 19, 1980. Then an administrative rule could be adopted permitting a clean cutoff as of the beginning of the taxable year that installment reporting is elected. Thus, any payment received on installment sales entered into before the first taxable year to which new Section 453A could apply

⁶⁹ I.R.C. § 453A concerning the use of the Installment Method for Dealers in Personal Property does not contain a provision, similar to old Sec. 453(c). See Act, *supra* note 43, at § 2(b), 94 Stat. 2253-4.

would not be included twice in income, and old Sections 453(c) and 481(d) would be truly repealed as was the obvious intent of the provision. It is expected that the regulations will reflect this result.

The Senate Finance Committee Report⁷⁰ indicates that under this new provision, a failure to report the full amount of gain from a sale may be treated as an election of the installment method. If the regulations follow Congressional intent, dealer/lessors who have leases re-characterized as sales on audit by the IRS should be permitted to utilize the installment method for reporting the gain from such "sales".

Despite a clear statement in the Senate Finance Committee Report⁷¹ that, "[e]xcept for an amendment relating to the election of the installment method by an accrual basis dealer, the substantive changes under the [Act] relate only to sales of realty and casual sales of personal property", considerable speculation has arisen concerning the possibility that dealers may be allowed to elect installment reporting for sales on account where only one payment is contemplated. This speculation was fueled by a sentence in the Finance Committee Report dealing with the elimination of the two-payment rule for casual sales of personal property. The report stated that:

It is anticipated that the Treasury Department will prescribe regulations to extend a similar rule to deferred payment sales by dealers in personal property.⁷²

It is not anticipated that the Treasury Department will issue regulations permitting dealers who do *not* sell "on the installment plan" to report open account sales on the installment method. New Section 453A still limits the use of the installment method by dealers to those who regularly sell personal property on the installment plan and gives regulation writing authority to the Treasury. In addition, it must be realized that, such a rule could result in virtually all accrual method taxpayers reporting their gross income from sales on a deferred basis, with a resulting revenue loss that might preclude any type of tax cut for years to come.

According to a statement on the Senate floor by Senator Russell Long,⁷³ the point of the sentence in the committee report was to have the Treasury Department consider the question of whether there are circumstances in which reliance on the two-payment rule is excessively formalistic. However, according to Senator Long, there was no intention to eliminate the statutory requirement that a dealer be selling on the installment plan to qualify for installment reporting. Based on a letter from the Assistant Secretary of the Treasury, Tax Policy, inserted in the Congressional record by Senator Long,⁷⁴ there is no doubt that the

⁷⁰ S. REP. NO. 1000, *supra* note 4, at 25.

⁷¹ S. REP. NO. 1000, *supra* note 4, at 8.

⁷² S. REP. NO. 1000, *supra* note 4, at 11.

⁷³ Cong. Rec. S16536 (daily ed. December 13, 1980).

⁷⁴ Cong. Rec. S16537 (daily ed. December 13, 1980).

Treasury Department views selling on the installment plan to be a prerequisite for installment method reporting by dealers in personal property.

Effective Date Provisions

Except as noted otherwise, the provisions discussed above apply to installment sales entered into in the first taxable year ending after the enactment of the Act, October 19, 1980. New Section 453(B)(f) applies to installment obligations becoming unenforceable after October 19, 1980. The amendments to Section 691 apply in the case of decedents dying after the date of enactment, and the amendments to Section 1038 apply to reacquisitions of real property by a taxpayer after the enactment date.⁷⁵

⁷⁵ Act, *supra* note 43, at § 6, 94 Stat. 2256.