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INSTALLMENT SALES AFTER THE TAX REFORM ACT OF 1986

By

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I. Introduction. The Tax Reform Act of 1986 eliminates or limits the use of installment reporting in many transactions. The Act fully disallows use of the installment method of reporting income (full disallowance) with respect to, for example, sales of property regularly traded on an established market. The Act disallows on a proportionate basis use of the installment method of reporting income (proportionate disallowance) with respect to, for example, certain sales of real property used in the seller's trade or business or held for production of rental income. Finally, the Act respects the installment method of reporting income for certain transactions, such as upon disposition of personal use assets.

[References to sections in this outline are to sections of the Internal Revenue Code of 1986. References to the "Act" mean the Tax Reform Act of 1986; "Blue Book" refers to the General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation (May 4, 1987); "Technical Corrections Bill" refers to the Technical Corrections Bill of 1987, H.R. 2636 and S. 1350, introduced on June 10, 1987;]

II. Installment Reporting Not Allowed (Full Disallowance). The Act treats certain installment sales as if all payments are received in the year of sale under section 453.

A. Publicly traded property. Because the taxpayer can easily sell publicly traded property for cash in the public market, Congress believed that such property does not present the liquidity concern that the installment method of reporting was designed to remedy. Blue Book, pages 490 - 491. Accordingly, Congress denied the use of the installment method for any installment sale of (i) stock or securities traded on an established securities market, or (ii) to the extent provided in regulations, property of a kind regularly traded on an established market. Section 453(k)(2).

1. Trade date. The Act eliminated the ability of a seller to treat the cash settlement date, which on established markets occurs five days after the trade date, as the day on which the gain is recognized under the installment method. This rule prevents taxpayers from disposing of stock or securities at the end of their taxable year and using the five-day period combined with the right to elect out of installment treatment to choose the taxable year in which to recognize the gain. The Act requires gain or loss to be recognized for federal income tax purposes by both cash and accrual method sellers on the day that the trade is executed. Section 453(k). Blue Book, page 498.

2. Property (other than stocks or securities). Future regulations may prohibit installment treatment for sales of other property traded on established markets (e.g., master limited partnership interests). Section 453(k)(2)(B).

3. Effective date. This rule applies to dispositions in tax years beginning after 1986.

B. Sales of personal property under revolving credit plan. Installment reporting is fully disallowed on dispositions of personal property under a revolving credit plan as defined in Treas. Reg. section 1.453-2(d). Section 453(k)(1).

1. Effective date. This change applies to taxable years beginning after 1986. However, income included may be spread forward up to four years with 15% recognized in the year of disposition, and 25%, 30%, and 30% recognized in the following three years, respectively.

C. Use of related parties, pass-through entities or intermediaries. Regulations may be issued to prevent the use of intermediaries, pass-through entities or related parties to avoid the rules disallowing installment method reporting. These regulations would have the same effective date as section 453(k). The regulations would apply to sales of property, a substantial portion of whose value is attributable to property that does not qualify for installment reporting. For example, the regulations may fully or partly disallow use of the installment method of reporting income with respect to the sale of stock in a wholly-owned corporation, the only assets of which are publicly traded stocks or securities. S. Rep't No. 99-313, 99th Cong. 2d sess. 131 (1986). However, the regulations may not disallow installment method reporting if the seller could not have sold directly, or caused the sale of, the publicly traded stocks or securities. For example, a

retiring partner in a large investment partnership sells his partnership interest for an installment obligation. A substantial portion of the value of the partnership consists of publicly traded stocks or securities. If the retiring partner could not have sold or caused the sale of the partnership's assets directly, the regulations would not disallow the installment method of reporting income. S. Rep't No. 99-313 at 131.

D. Recapture income. In the case of an installment sale of property resulting in the realization of "recapture income," section 453(i) requires recognition of the recapture income in the year of the disposition. The definition of "recapture income" has been expanded to include, not only recapture under sections 1245 and 1250, but also so much of section 751 as relates to section 1245 or 1250. Section 453(i)(2).

1. Effective date. This change applies, with certain exceptions, to dispositions made after June 6, 1984.

E. Related party sales. Before the Act, the Code disallowed the installment method for sales of depreciable property to related parties (such as sales to a spouse or an 80%-owned entity). The Act materially expands the definition of related persons so that installment treatment is fully disallowed for sales to or between controlled entities and trusts in which the seller (or spouse) is a beneficiary. Sections 453(g) and 1239 (section 453(g)(2) provides an exception from this full disallowance rule for an installment sale that did not have as one of its principal purposes the avoidance of federal income tax).

1. Resale rules. The definition of related person has also been expanded for purposes of the resale rules under section 453(e). These rules accelerate gain recognition when an installment sale to a related party is followed by a resale within a specified time period. Related persons for purposes of section 453(e) now include those persons described in section 267(b). Sections 453(e)(1) and (f)(1).

2. Effective date. The expanded related party sale rules apply generally to sales after October 22, 1986 (date of enactment) in tax years ending after the date of enactment. However, the changes do not apply to sales made after August 14, 1986 which are made pursuant to a binding contract in effect on August 14, 1986 and all times thereafter.

F. Election not to use installment method. Of course, the installment method of reporting is disallowed if the

taxpayer elects not to use the installment method. Section 453(d).

III. Installment Reporting Permitted (No Disallowance). Neither the full disallowance rules nor the proportionate disallowance rules apply to installment sales of certain types of properties. Of course, even with these sales a taxpayer can elect out of the installment method.

A. Sales of personal use property. The Act does not alter installment reporting on sales of "personal use property" by an individual. Personal use property means any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212. Sections 453C(e)(1)(B)(i) and 1275(b)(3). Thus, neither the full nor proportionate disallowance rules apply to sales of residences, cars, boats and other property not used in business or income-producing activities.

B. Sales of farm property. The Act does not alter installment reporting on sales of any property used or produced in the trade or business of farming. For example, neither the full nor proportionate disallowance rules would apply to an installment obligation arising from the sale of crops or livestock held for slaughter, as well as timber and farm land and buildings. Section 453C(e)(1)(B)(ii) and Blue Book, page 492, n. 14.

1. Farming - defined. "Farming" is defined in sections 2032A(e)(4) or (5). The term "farm" includes any place for stock, dairy, poultry, fruit, furbearing animal, and includes truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands. Farming also includes the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.

C. Certain sales of real property used in a trade or business or held for the production of rental income. Installment sales by nondealers of real property used in a trade or business or held for the production of rental income for a price of \$150,000 or less are not subject to the full or proportionate disallowance rules. Section 453C(e)(1)(A)(i)(III). All sales that are part of the same transaction or a series of related transactions are aggregated to determine whether the \$150,000 threshold has been exceeded. Section 453C(e)(1)(A)(i)(III).

D. Sales of pure investment real property. The Blue Book provides that nondealer sales of pure investment real

property are not subject to the proportionate disallowance rules. Blue Book, page 492, n. 13. For example, a nondealer installment sale of a parcel of undeveloped land that is held for investment only (and is not held for sale to customers, or for rental, or for use in a trade or business) would not be subject to the proportionate disallowance rules. Id.

E. Sales of interests in closely-held entities and other property not publicly traded. The proportionate disallowance rules do not apply to sales of interests in closely-held entities and other property that is not publicly traded if the seller is not a dealer in such property. However, the Treasury has broad powers to prevent avoidance of the rules through the use of related parties, pass-through entities, or intermediaries. See section II.C and IV.C.5 of this Outline.

F. Sales from manufacturers to dealers. Section 811(c)(2) of the Act provides an exception from the proportionate disallowance rules for installment sales of tangible personal property by the manufacturer of the property (or an affiliate of the manufacturer) to a dealer if: (i) the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, (ii) the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine-month period following the sale to the dealer, and (iii) the aggregate face amount of the installment obligations otherwise qualifying for this exception equal at least 50% of the total sales to dealers that give rise to such receivables using the weighted average of the taxpayer's receivables computed on a monthly basis. Blue Book, pages 497-498.

G. Sales of timeshares and residential lots. If the dealer elects, the proportionate disallowance rule will not apply to dealer sales to an individual of "timeshares" or of unimproved residential lots, the development of which will not be done by the seller or an affiliate of the seller. Section 453C(e)(4). The purchaser's payment must not be secured through federal or private insurance or guaranteed, unless the insurer or guarantor is an individual.

1. Timeshares. The term means a right to use a specified parcel of residential real property for a period not exceeding six weeks per year. The term also includes a right to use campground sites in designated locations over ascertainable periods of time for recreational (not residential) purposes. Section 453C(e)(4)(A)(i)(I); Blue Book, page 497.

2. Aggregation of timeshares. If an individual or related person owns more than one timeshare in a single parcel of residential real property, then all of the timeshares of the individual and the related parties are aggregated for purposes of determining whether the six-week threshold has been exceeded. Section 453C(e)(4)(A); Blue Book, page 497.

3. Unimproved residential lot. A parcel of land is not considered improved or developed if it merely has been provided with the benefits of common infrastructure items such as roads and sewers. Blue Book, page 497, n. 23.

4. Effect of election out of proportionate disallowance rule. If the dealer satisfies the conditions of this exception and elects to have this exception apply, the proportionate disallowance rules do not apply to the installment obligation received by the dealer. However, the seller must pay interest on the tax deferred by the installment method (determined without regard to any interest deduction for such interest). The interest is based upon the applicable federal rate in effect at the time of the sale (without regard to the three-month lookback rule under section 1274(d)(2)). Interest is computed for the period from the date of sale to the date on which payment is received. Section 453C(e)(4)(B) and (C); Blue Book, page 497.

IV. Installment Sales Subject to Proportionate Disallowance.

A. Overview. The proportionate disallowance rules under section 453C apply only to certain types of installment obligations called "applicable installment obligations." If the seller receives an applicable installment obligation, the seller must determine whether he possesses any "allocable installment indebtedness" that must be allocated to the applicable installment obligations. If the seller has no allocable installment indebtedness for the taxable year then the seller is not treated as having received a deemed payment in such taxable year on the applicable installment obligations. If the seller has allocable installment indebtedness for the taxable year, then the seller is treated as having received a cash payment on the applicable installment obligation at the end of the taxable year. The deemed payment is multiplied by the gross profit ratio to compute the taxable gain resulting from the allocable installment indebtedness. Actual note payments received in future years are not taxed to the extent of the deemed payments previously taxed on that note.

B. Installment sales subject to proportionate disallowance rules. The proportionate disallowance rules under section 453C apply only to "applicable installment obligations." Applicable installment obligations ("AIO") are installment obligations arising out of the following transactions:

1. Installment sales of personal property after February 28, 1986 by dealers in such property;
2. Installment sales of real estate after February 28, 1986 by dealers in such real estate; and
3. Installment sales after August 16, 1986 of real property used in a trade or business or held for the production of rental income, if the sales price of such property exceeds \$150,000. Section 453C(e)(1)(A).

Section 108(f) of the Technical Correction Bill clarifies that an AIO does not include an installment obligation arising from a sale of personal property pursuant to a revolving credit plan or from the sale of publicly-traded property. The Technical Corrections Bill also clarifies that an AIO includes those held by the seller or any person if the basis of such obligation in the hands of such person is determined (in whole or in part) by reference to the basis of such obligation in the hands of another person, and such obligation was an AIO in the hands of such other person.

C. Proportionate disallowance formula.

1. Definition of allocable installment indebtedness. Allocable Installment Indebtedness (AII) means the specific dollar amount of the seller-taxpayer's debt to third party creditors that is deemed paid to the seller-taxpayer on his AIOs. This specific dollar amount is treated as a principal payment on the seller-taxpayer's AIOs. Deemed payments apply first to the taxable year's AIOs then to AIOs from previous taxable years in chronological order. Section 453C(d)(2). If the seller-taxpayer holds more than one AIO in each particular taxable year, the amount of the deemed payment is allocated among the obligations based on outstanding principal balances.

2. Calculation of AII. AII is computed as follows:

- a. Calculate "installment percentage" by dividing (i) the face amount of all of the taxpayer's AIOs outstanding at the end of the taxable year by (ii) the sum of the total face amount of all of the taxpayer's installment obligations (IO) held by the taxpayer at the end of the year plus the total

amount of the taxpayer's adjusted bases in all of his business and rental income assets (excluding IOs). IOs include all installment obligations whether or not AIOs, except those attributable to dispositions of personal use property, personal property on revolving credit, or publicly-traded property.

b. Multiply the "installment percentage" by the "average quarterly indebtedness" (AQI). AQI is the amount of the taxpayer's indebtedness to third parties, computed quarterly. A taxpayer's AQI includes all indebtedness of the taxpayer other than debt substantially or fully collateralized with personal use property or farm property. Indebtedness includes accrued expenses and payables even if the taxpayer is on the cash method. Blue Book, page 493. If the taxpayer has no installment obligations arising during the taxable year from dealer sales of property, the taxpayer computes AQI based only on his debt at the end of the taxable year, rather than quarterly. Section 453C(b)(4). The Technical Corrections Bill would dictate the use of the annual AQI if no dealer AIO exists at the taxable year end.

c. Reduce the resulting amount of AII by any AII recognized in an earlier year on the AIOs that has not been recovered through actual payments.

3. Effect of subsequent actual payments. Any actual payments made with respect to an AIO in a subsequent year are not treated as taxable payments to the extent the aggregate amount of such actual payments does not exceed the amount of prior deemed payments on that debt. This rule permits the taxpayer to recover previously recognized AII (deemed payments) tax-free. Section 453C(c)(1). Actual payments in excess of the AII allocable to the obligations are reported under the provisions of section 453. For purposes of the AII computation in subsequent years, to the extent actual payments are received tax-free, the AII balance is reduced dollar for dollar. Section 453C(c)(2).

4. Aggregation rules. All persons treated as a single employer under section 52(a) or 52(b) are treated as one taxpayer for purposes of applying the proportionate disallowance formula. Section 453C(e)(2). Section 52 applies to a controlled group of corporations and also to two or more businesses (corporations, partnerships, proprietorships) under common control. Consequently, each member of the group

is treated as having all of the assets and liabilities of every other member of the group.

a. In applying the proportionate disallowance rule to the group, AII is computed using the aggregate of all assets and all liabilities of the members of the group. Blue Book, page 494.

b. The combined AII is allocated pro-rata to the AIOs held by the members of the group (regardless of the amount of any outstanding debt of any particular member.) Id.

c. Generally, indebtedness between members of the group would be disregarded in computing total assets and liabilities. Id.

d. For purposes of making the proportionate disallowance computation, the adjusted basis of any asset transferred from one member to another is reduced by the portion of the gain that has not been recognized or otherwise has been deferred as of the time of the computation, either under the consolidated return regulations (Treas. Reg. section 1.1504-13) or because the gain on transfer qualifies for installment treatment. Id.

5. Use of related parties, pass-through entities or intermediaries. Regulations may be issued to prevent the use of related parties, intermediaries or pass-through entities to avoid the proportionate disallowance rules.

a. The regulations may treat any corporation, partnership, or trust as related to its shareholders, partners, or beneficiaries, as the case may be, where the proportionate disallowance rule would otherwise be avoided. Blue Book, page 494.

b. The regulations may aggregate the assets of related parties for purposes of applying the proportionate disallowance rules. (e.g., aggregating the assets and liabilities of a partnership and each of its partners to determine the amount of proportionate disallowance arising from an installment sale of partnership assets). Id.

c. The Blue Book also provides that the regulations may apply in appropriate circumstances to all transactions after the general effective

date of 453C, even if the transaction occurs before the issuance of regulations. Blue Book, page 495.

6. Effect of proportionate disallowance rule. The provisions of section 453C result in the seller being treated as receiving a deemed payment on his AIOs. The proportionate disallowance rules do not affect the amount the seller is deemed to receive as a result of (i) realizing recapture income under section 453(i) or (ii) having mortgage in excess of basis.

7. Phase-in rules. Generally, the proportionate disallowance rules apply to taxable years beginning after 1986. However, the Technical Corrections Bill provides that an AIO arising after February 28, 1986, but in a taxable year before the first taxable year ending after December 31, 1986, is treated as arising on the first day of the first taxable year of the taxpayer ending after December 31, 1986. Special rules designed to prevent bunching of AII (deemed payments) in the first taxable year after 1986 apply to installment sales of dealer real property and dealer personal property.

a. Installment sales of dealer real property. Any gain attributable to AII allocated to an AIO that arises in the first taxable year of the taxpayer ending after December 31, 1986, is taken into account ratably over three taxable years beginning with such first taxable year. For an AIO arising in the second taxable year of the taxpayer ending after December 31, 1986, any such gain is recognized ratably over the two taxable years beginning with such second taxable year. Act section 811(c)(6); Blue Book, page 499.

b. Installment sales of dealer personal property. Any increase in the tax liability of the taxpayer for the first taxable year of the taxpayer ending after December 31, 1986 because of the proportionate disallowance rules is imposed ratably over the three taxable years beginning with the first taxable year. Any increase in tax liability for the second taxable year ending after December 31, 1986 because of the proportionate disallowance rules is imposed ratably over the two taxable years beginning with the second taxable year. Act section 811(c)(7); Blue Book, page 499.

8. Examples: The Blue Book at page 495-496 contains the following example:

a. During 1987, Dealer (calendar year taxpayer) sells a parcel of real estate for an installment note with a face amount of \$90,000 and adequate stated interest. Buyer makes no payments on the note in 1987. Dealer's average quarterly indebtedness (AQI) for 1987 is \$200,000. Dealer's adjusted basis in its business and rental income assets (other than the \$90,000 installment obligation) is \$310,000 at the end of 1987. Dealer's AII is \$45,000, computed as follows:

- (i)
$$\frac{\text{Face amounts of all AIOs}}{\text{Face amount of all IOs} + \text{adjusted basis of assets}} \times \text{AQI} = \text{AII}$$
 (before adjustment)
- (ii)
$$\frac{90,000}{90,000 + 310,000} \times 200,000 = \$45,000$$
- (iii) Subtract prior year's AII (\$0) from \$45,000.

Result in 1987: Dealer is treated as receiving a payment of \$45,000 on the \$90,000 AIO. To determine gain on 1987 note, the deemed payment is multiplied by the gross profit ratio.

b. During 1988, Dealer sells another parcel of real estate for an installment note with a face amount of \$110,000 and adequate stated interest. Dealer received no actual payments on the 1987 or 1988 installment obligation. Dealer's average quarterly indebtedness (AQI) for 1988 is \$300,000. Dealer's adjusted basis in its business and rental income assets (other than the \$90,000 and \$110,000 installment obligations) is \$400,000 at the end of 1988. Dealer's AII for 1988 is \$55,000, computed as follows:

- (i)
$$\frac{\text{Face amount of all AIOs}}{\text{Face amount of all IOs} + \text{adjusted basis of assets}} \times \text{AQI} = \text{AII}$$
 (before adjustment)
- (ii)
$$\frac{200,000}{200,000 + 400,000} \times 300,000 = 100,000$$
- (iii) subtract prior year's AII (\$45,000) from AII for current year (\$100,000).
AII = \$55,000.

Result in 1988: Dealer is treated as receiving a payment of \$55,000 on the \$110,000 AIO. To determine gain on 1988 note, the deemed payment is multiplied by the gross profit ratio.

c. If Buyer had made a payment of \$30,000 on the 1987 \$90,000 AIO, Dealer's AII for 1988 would be \$74,000, computed as follows: (this part c. of the example is not in the Blue Book)

- (i)
$$\frac{\text{face amount of all AIOs}}{\text{face amount of all IOs} + \text{adjusted basis of assets}} \times \text{AQI} = \text{AII}$$
- (ii)
$$\frac{\$60,000 \text{ (1987 AIO)} + \underline{110,000 \text{ (1988 AIO)}}}{170,000 + 400,000} \times 300,000 = \$89,000$$
- (iii) subtract from \$89,000, the prior year's recognized AII of \$15,000 (the \$45,000 recognized in 1987 reduced by the \$30,000 payment received in 1988).
AII is \$74,000

Result in 1988: Dealer is treated as having received a payment of \$74,000 on the \$110,000 AIO, rather than a \$55,000 deemed payment if Buyer had not made a \$30,000 payment on the 1987 AIO.

d. During 1989, Dealer sells another parcel of real estate for an installment note with a face amount of \$130,000 and adequate stated interest. Dealer received no payments on the 1988 or 1989 obligations. However, the \$90,000 1987 AIO is paid in full. Dealer's average quarterly indebtedness (AQI) for 1989 is \$500,000. Dealer's adjusted basis in its business and rental income assets (other than the \$110,000 and \$130,000 installment obligations) is \$360,000 at the end of 1989. Dealer's AII for 1989 is \$145,000, computed as follows:

- (i)
$$\frac{\text{face amount of all AIOs}}{\text{face amount of all IOs} + \text{adjusted basis of assets}} \times \text{AQI} = \text{AII} \quad \text{(before adjustment)}$$
- (ii)
$$\frac{\$0 \text{ (1987 obligation)} + \$110,000 \text{ (1988 obligation)} + \underline{\$130,000 \text{ (1989 obligation)}}}{240,000 + 360,000} \times 500,000 = \$200,000$$
- (iii) subtract balance of prior years' recognized AII of \$55,000 (1987 AII of \$45,000 plus 1988 AII of \$55,000 minus \$45,000). The \$90,000 payment on the 1987 AIO would be treated as follows: (1) the first \$45,000 of the payment would not result in additional gain on the 1987 AIO and would reduce

the amount of AII with respect to the 1987 AIO which was \$45,000; (2) the balance of the payment (\$45,000) would constitute a cash payment on the note resulting in the recognition of additional gain under the installment method.

AII for 1989 = \$145,000

Result in 1989: because the AII for 1989 of \$145,000 exceeds the amount of AIOs arising in 1989 of \$130,000, Dealer is treated as having received a payment in 1989 of \$130,000 on the \$130,000 1989 AIO, and a payment of \$15,000 on the \$110,000 1988 AIO. To determine the gain on the 1989 and 1988 AIOs, the deemed payments are multiplied by the gross profit ratio of the note to which the deemed payment relates.

V. Alternative Minimum Tax on Installment Sales. In computing alternative minimum taxable income, the installment method of reporting income is not available to any sale of property which gives rise to an AIO under section 453C. Accordingly, for minimum tax purposes, all payments to be received on an AIO are treated as received in the year of sale. Section 56(a)(6).

A. Carryforward credit. The minimum tax generated by section 56(a)(6) is included in a special carryforward credit under section 53 that can be applied against the taxpayer's future regular tax liability. Section 53(d)(1)(B)(ii).