Dealing with Installment Sales 35 Years After the Installment Sales Revision Act of 1980

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Section 453 – Basic Rules
Installment Sale

- Income from an installment sale is generally reported under the installment method.
  - §453(a).
- An installment sale is defined as a disposition of property where at least one payment is to be received after the year of disposition.
  - Dealer dispositions and sales of inventory generally do not qualify.
  - §453(b); Treas. Reg. §15A.453-1(b)(1).
Installment Sale

"Dealer disposition" is defined as:

- Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan; and
- Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

Similar language is used to define "dealer" property in §1221(a)(1).

§453(l).
Special Exceptions for Dealer Property

- Special exceptions allow installment sale treatment for certain specified types of dealer property:
  - Farm property.
    - Property used in the trade or business of farming.
    - §453(I)(2)(A); §2032A(e)(4) and (5).
  - Timeshares.
    - Timeshare right to use or a timeshare ownership interest in residential real property for not more than six weeks per year, or a right to use specified campgrounds for recreational purposes.
  - Residential lots.
    - Any residential lot, but only if the taxpayer (and any related person) is not to make any improvements with respect to such lot.
  - Interest charge.
    - An interest charge is imposed on the deferred gain from sales of timeshares and residential lots (but not farm property).
    - §453(I)(3).
Installment Method

Under the installment method, income on a disposition is recognized each year in an amount equal to:

- the payments received that year, multiplied by
- the "gross profit ratio," i.e., the ratio of:
  - the gross profit realized or to be realized, to
  - the total contract price.

§453(c); Treas. Reg. §15A.453-1(b)(2).
Installment Method

- Gross profit is selling price less adjusted basis.
- Total contract price is selling price reduced by qualifying indebtedness assumed or taken subject to by the buyer.
  - Selling price is gross selling price.
    - No reduction for existing mortgage or other debt assumed or taken subject to by the buyer.
    - No reduction for selling expenses.
    - Does not include interest.
  - Qualifying indebtedness includes:
    - Mortgage or other indebtedness secured by the property,
    - Other debt incurred or assumed by the buyer incident to acquisition.
    - Does not include obligation incident to disposition, e.g., legal fees.
Installment Method

- What is a payment?
  - Generally does not include the installment obligation itself.
    - Even if guaranteed by a third party, including a standby letter of credit.
  - Payments include amounts actually or constructively received, including:
    - amounts secured by cash or cash equivalent.
    - cash and other property.
      - marketable securities.
      - indebtedness payable on demand or readily tradable.
    - indebtedness of anyone other than the buyer.
  - Treas. Reg. §15A.453-1(b)(3)(i) and (iii) and (e).
Installment Method

- Example – Sale Free and Clear of Debt.
  - A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A’s hands, to B for $100,000: $10,000 down and $90,000 in equal annual installments over the next nine years, with adequate stated interest.
  - A’s basis is $38,000 and selling expenses are $2,000.
  - Gross profit is $60,000 ($100,000 selling price less $40,000 basis, including selling expenses).
  - Gross profit ratio is 3/5 ($60,000 gross profit divided by $100,000 contract price).
  - Accordingly, of each $10,000 payment, $6,000 is capital gain and $4,000 is tax-free recovery of basis.
  - Treas. Reg. §15A.453-1(b)(5), example (1).
Installment Method

- Example – Buyer Assumes (or Takes Subject to) Seller Mortgage Debt.
  - Same facts as prior example except:
  - C sells Whiteacre to D for $160,000:
    - $10,000 down;
    - D’s assumption of (or taking subject to) C’s longstanding $60,000 mortgage loan; plus
    - $90,000 in equal annual installments over the next nine years, with adequate stated interest.
  - A’s basis is $90,000 and A has no selling expenses.
Installment Method

► Example – Buyer Assumes (or Takes Subject to) Seller Mortgage Debt.
  ► Contract price is $100,000 ($160,000 selling price less $60,000 debt assumed or taken subject to by buyer).
  ► Gross profit is $70,000 ($160,000 selling price less $90,000 basis).
  ► Gross profit ratio is 7/10 ($70,000 gross profit divided by $100,000 contract price).
  ► Accordingly, of each $10,000 payment, $7,000 is capital gain and $3,000 is tax-free recovery of basis.
  ► Treas. Reg. §15A.453-1(b)(5), example (2).
Installment Method

- Any excess of liabilities assumed or taken subject to by the buyer over the taxpayer’s basis in the property generally triggers year of sale gain.
  - Treas. Reg. §15A.453-1(b)(3) and (5), example (3).
  - The regulations require such recognition of gain even if the seller takes back a wrap-around mortgage.
    - Treas. Reg. §15A.453-1(b)(3)(ii) and (5), example (5).
    - However, case law provides some support for deferral through wrap-around mortgages.
      - Stonecrest v. Comm’r, 24 TC 659 (1955);
Contingent Installment Payments

- If the installment sale provides for contingent payments subject to a stated maximum selling price, the taxpayer allocates basis using the stated maximum price as the selling price.
  - Any remaining basis is deductible if and when no further payments can be due.
Contingent Installment Payments

- If the installment sale provides for contingent payments that are not subject to a stated maximum selling price but are limited to a fixed period of time, the taxpayer allocates basis ratably over the entire period.
  - Any remaining basis can be deducted if and when no further payments can be due, i.e., at the end of the fixed payment period.
  - May permit acceleration of basis recovery if payments are backloaded.
  - How significant does the contingency have to be?
Contingent Installment Payments

If the installment sale provides for contingent payments that are neither limited to a stated maximum selling price or a fixed period of time, the regulations state that the transaction may not be a sale for federal income tax purposes:

- "Arrangements of this sort will be closely scrutinized."
- If the arrangement qualifies as a sale, basis is recovered ratably over 15 years.
Contingent Installment Payments

- Notwithstanding the normal basis recovery rules:
  - The taxpayer may use an alternative method if the taxpayer is able to demonstrate, prior the extended due date of the tax return for the year of sale, that the normal basis recovery rules will substantially and inappropriately defer recovery of basis.
  - Similarly, the IRS may require an alternative method if the IRS finds that the normal basis recovery rules will substantially and inappropriately accelerate recovery of basis.
  - Taxpayer can prevail upon showing that:
    - the IRS method is not reasonable; or
    - it is not reasonable to conclude that the normal method is not likely to recover basis twice as fast as the IRS method.
Election Out of Installment Method

- The taxpayer has the right to elect out of the installment method.
  - §453(d).
  - The election is made on a timely filed tax return for the year of the installment sale.
  - The taxpayer can make the election by reporting the entire gain realized in the year of sale based on the selling price, including the full face amount of any installment obligation.
Limitations on Use of Installment Method
Resale Rule

If the taxpayer disposes of property in an installment sale to a related person (the "first disposition") and

the related person later disposes of the property (the "second disposition"),

then the amount realized by the related person on the second disposition is treated as amount realized by the taxpayer on the first disposition.

The "resale rule."

§453(e).
Resale Rule

For purposes of the resale rule, a related person includes:

- A person whose stock would be attributed the taxpayer under §318(a)(1), (2) or (3); and
- A person with a relationship to the taxpayer described in §267(b).
- §453(f)(1).

This definition is quite broad.

- Related person is defined under most Code provisions by reference to either §318(a) or §267(b), but usually not both.
Resale Rule

- Resale rule generally does not apply if second disposition is more than two years after first disposition.
  - No time limit for sale of marketable securities.
    - Marketable securities are defined in §453(f)(2).
  - Two-year period tolled if and when related person’s risk of loss is substantially diminished through put, call, short sale, etc.
  - §453(e)(2), somewhat similar to §1031(g).
Resale Rule

- Gain to the taxpayer under resale rule for any year is limited to the excess of:
  - the lesser of:
    - the total amount realized by the related person with respect to any second disposition through the end of the year; or
    - the total contract price for the first disposition; over
  - the sum of:
    - total payments received by the taxpayer on the first disposition through the end of the year; plus
    - the total amount treated as received by the taxpayer under the resale rule in prior years.
  - §453(e)(3).
Resale Rule

- A second disposition that is not a sale or exchange is treated as a sale at fair market value.
  - §453(e)(4).
- Payments received on first disposition are treated as tax-free to extent such payments do not exceed deemed payments under resale rule in prior years.
  - §453(e)(5).
Resale Rule

- Exceptions to resale rule are provided for:
  - Reacquisition of stock by issuing corporation;
  - Involuntary conversions; and
  - Death of taxpayer or related person.
  - §453(e)(6).
- Another exception is provided “if it is established to the satisfaction of the [IRS] that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.”
  - §453(e)(7).
Resale Rule

- Extension of statute of limitations.
  - Period for assessment of a deficiency attributable to gain under the resale rule is extended to two years after the taxpayer furnishes notice of the second disposition.
  - §453(e)(8).
Sale of Depreciable Property to Related Person

- If the taxpayer disposes of depreciable property in an installment sale to a related person, then the installment method is generally not available.
  - The installment method is permitted for contingent payments "with respect to which the fair market value may not be reasonably ascertained."
  - Purchaser may not include amounts in basis until included in taxpayer's amount realized.
  - Another exception is provided "if it is established to the satisfaction of the [IRS] that the disposition did not have as one of its principal purposes the avoidance of Federal income tax."
  - §453(g).
Sale of Depreciable Property to Related Person

For purposes of this rule, a related person includes:

- a related person under §1239(b); and
- if the taxpayer is a partnership, a second partnership under more than 50 percent common ownership as described in §707(b)(1)(B).
- §453(g)(3).

Depreciable property includes property depreciable in the hands of the related person under §167.
- §453(f)(7).
Recapture Income

- Recapture income is triggered in the year of sale and is not deferred under the installment method.
  - §453(i)(1)(A).
- Any gain in excess of recapture income can be deferred under the installment method.
  - §453(i)(1)(B).
- Recapture income is defined as the total amount that would be ordinary income under §1245 or §1250 (or §751) if all payments were received in the year of sale.
  - §453(i)(2).
- Presumably includes §291(a)(1) recapture.
Sales of Publicly Traded Property

- The installment method is not permitted for:
  - installment sales of stock or securities traded on an established securities market; or
  - dispositions of personal property under a revolving credit plan.
    - Payments for such dispositions are treated as received in the year of sale.
    - §453(k).
  - Income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory.
Interest Charge
Interest Charge

The deferred tax liability for an installment sale is generally subject to an interest charge if:

- The total sale price exceeds $150,000;
- A portion of the payments are still outstanding at the end of the year; and
- The face amount of all installment obligations held by the taxpayer that arose during the year and are still outstanding at the end of the year exceeds $5,000,000.

For this purpose, except as provided in regulations, installment obligations include those held by all other taxpayers treated as a single employer with the taxpayer under §52(a) or (b).

§453A(a) and (b).
Interest Charge

- Installment payments are disregarded for sales of:
  - personal use property, as defined in §1275(b)(3); and
  - farm property, as defined above.
  - §453A(b)(3).
- A separate interest charge applies to timeshares and residential lots.
  - §453A(b)(4).
Interest Charge

The interest charge is equal to the product of:

- The applicable percentage of the deferred tax liability with respect to the installment sale; times
- The underpayment rate in effect under §6621(a)(2) for the last month of the year.
- §453A(c)(2).

The interest charge is treated as interest paid or accrued during the year in determining the taxpayer’s interest deduction under §163.
- §453A(c)(5).

Interest charge applies at partner level.
- Announcement 89-33.
Interest Charge

The "deferred tax liability" is the product of:

- The installment gain not yet recognized at the end of the year; times
- The maximum federal income tax rate under §1 or §11, as appropriate.
  - In the case of long-term capital gain, takes into account the tax rate on net capital gain under §1(h) or §1201, as appropriate.
- §453A(c)(3).
Interest Charge

The "applicable percentage" is the quotient of:

- The total face amount of such installment obligations outstanding at the end of the year in excess of $5,000,000; divided by
- The total face amount of such installment obligations outstanding at the end of the year.

Again, for this purpose, except as provided in regulations, installment obligations include those held by all other taxpayers treated as a single employer with the taxpayer under §52(a) or (b).

§453A(c)(4).
Pledge Rule
Pledge Rule

If the taxpayer pledges an installment obligation as security for indebtedness, the net proceeds of the secured indebtedness are generally treated as a payment received on the installment obligation at the later of:

- The time the indebtedness becomes secured indebtedness; or
- When the proceeds of such indebtedness are received by the taxpayer.

§453A(d)(1).
Pledge Rule

- The amount treated as received by the taxpayer under the pledge rule cannot exceed the excess of:
  - The total contract price; over
  - Any portion of the total contract price received (or treated as received) before the current application of the pledge rule.
  - §453A(d)(2).

- Payments on installment obligations after application of the pledge rule are treated as tax-free to extent such payments do not exceed prior deemed payments under the pledge rule.
  - §453A(d)(3), similar to §453(e)(5).
Dispositions of Installment Obligations
Dispositions of Installment Obligations

If an installment obligation is satisfied at other than its face value or is sold or exchanged, the taxpayer has taxable gain (or loss) to the extent of the excess (or shortfall) of the amount realized over the basis in the installment obligation.

Similarly, if an installment obligation is distributed, transmitted or otherwise disposed of other than by sale or exchange, the taxpayer has taxable gain (or loss) to the extent of the excess (or shortfall) of the fair market value of the obligation over the basis in the obligation.

§453B(a)(1).
Dispositions of Installment Obligations

The foregoing gain recognition does not apply to:

- Transmissions of installment obligations at death (other than under §691).
- Distributions in certain tax-free corporate liquidations under §337.
- Tax-free transfers between spouses under §1041(a).
  - §453B(c), (d) and (g).
- Nonrecognition transfers under §351, 361, 721 and 731 (except for gain under §736 and §751).
  - Treas. Reg. §1.453-9(c)(2); but is this reg still valid?
- Special rules apply to insurance companies.
  - §453B(e).
Dispositions of Installment Obligations

▶ An installment obligation that is cancelled or becomes unenforceable is treated as disposed of other than in a sale or exchange.
▶ If the obligor and obligee are related persons (under §453(f)(1)), the fair market value of the obligation is treated as not less than its face amount.
▶ §453B(f).
Section 331 Corporate Liquidation

The shareholder’s receipt in a §331 liquidation of an installment obligation acquired by the liquidating corporation in a sale or exchange by the corporation within 12 months after adoption of a plan of complete liquidation that is completed within that 12-month period is treated as received in exchange for the shareholder’s stock and, thus, is generally eligible for installment sale reporting.

This rule applies to a corporation’s sale of dealer property only if the sale is a bulk sale of substantially all such dealer property to a single buyer in a single sale transaction.

§453(h)(1)(A) and (B); Treas. Reg. §1.453-11.
Section 331 Corporate Liquidation

- This deferral rule does not apply to the extent the installment obligation is attributable to the corporation’s disposition of depreciable property if the obligor of the installment obligation (i.e., the buyer of the corporate assets) is:
  - married to the shareholder; or
  - related to the shareholder under §1239(b).
  - §453(h)(1)(C), similar to §453(g)(1).
Liquidation of S Corporation

- No gain or loss is recognized by an S corporation in respect of a distribution of an installment obligation in complete liquidation of an S corporation if gain from the receipt of the installment obligation is deferred at the shareholder level under §453(h)(1).
- §453B(h).
Interplay with Section 1031
Installment Sales and Busted Exchanges

- Taxpayer can report installment note from buyer of the relinquished property under §453 installment method.

- Special rule overrides general rule that installment method is allowed only for indebtedness of the buyer, which would otherwise be the qualified intermediary ("QI") under the fiction of the §1.1031-1(k) regs.

- Reg. §1.1031(k)-1(j).
Installment Sales and Busted Exchanges

- If sale and receipt of cash from QI straddle two taxable years, Reg. §1.1031(k)-1(j) permits taxpayer to report taxable gain under §453 installment method.
- Assumes taxpayer transfers property through a QI and still has a bona fide intention to complete a like-kind exchange at end of year one.
Installment Sales and Busted Exchanges

- Installment gain is generally taxable in year cash is received.
  - However, gain is triggered in year one to extent of:
    - Liabilities in excess of basis.
    - Depreciation recapture under §1245, §1250 and §291(a)(1).
  - Interest charge under §453A(c).
    - Applies at partner level.
      - Announcement 89-33.
Partnership Exchange for Property Plus Buyer’s Note

➤ Suppose a partnership intends to sell its real property.

➤ Some partners wish to do a tax-free like-kind exchange; others wish to get cash.
  ➤ If partnership exchanges property for replacement property plus cash, allocation of gain attributable to cash to exiting partners may lack substantiability.
  ➤ Purchase of exiting partners’ interests requires larger purchase price for replacement property.
  ➤ Distribution of tenancy-in-common interests soon before sale ("drop and swap") raises many issues.
Partnership Exchange for Property Plus Buyer’s Note

Solution: Partnership exchanges for replacement property plus boot but, in lieu of cash, partnership takes buyer’s installment note.

- Buyer’s note may qualify for deferral to the partnership under §453.
- Partnership takes zero basis in note.
  - Partnership must allocate all carryover basis first to the replacement property, leaving no basis to be allocated to the note.
Partnership Exchange for Property Plus
Buyer’s Note

- Partnership later distributes buyer’s installment note.
  - Distribution of note is tax-free to partnership and exiting partners.
    - See Reg. §1.453-9(c)(2) and Prop. Reg. §1.453B-1(c)(1)(i)(C).
  - Exiting partner takes substituted basis in note.
  - Section 734 inside basis step-down may be required.
    - Elective or mandatory §754 election.
    - To the extent the exiting partner takes stepped-up basis in note.
Partnership Exchange for Property Plus
Buyer's Note

- Timing of partnership distribution of buyer's installment note.
  - Distribution of note immediately or soon after exchange may be vulnerable to recast under step transaction doctrine.
    - See, e.g., *Gregory v. Helvering*.
    - Best to wait some period of time after sale before distribution.
  - If recast, partnership receipt and distribution of note may be disregarded, so that note is taxable at partnership level.
Other Issues
Determining Principal Amount of Installment Obligation

What is the principal amount ("issue price") of an installment obligation?

The issue price is the stated principal amount (the face amount) if the obligation provides adequate stated interest, i.e., interest at or above the applicable federal rate (the "AFR").

Otherwise, the issue price is equal to the present value of all payments under the installment obligation using the applicable federal rate ("AFR").

Fair market value is used in cases of "potentially abusive transactions."

§1274(b) and (c)(2).
Cherry Picking

If the taxpayer sells multiple assets, some of which are eligible for installment method and some of which are not, will a provision in the sale agreement that allocates installment payments to the eligible assets and cash to the ineligible assets be respected for federal income tax purposes?

The authority and guidance is favorable.

Section 736 Payments Distinguished

- Deferred retirement payments to partners generally qualify for deferral under §736. This treatment is more advantageous that installment reporting under §453 because, under §736:
  - no interest charge on the deferred tax liability; and
  - immediate basis recovery.
- §736.
No Basis Step-up at Death

► If the taxpayer dies before the installment obligation is paid in full, the taxpayer’s estate will not be entitled to a basis step-up at death under §1014(c).
► §691(a)(4); Treas. Reg. §1.453-9(e).
► Thus, a transaction might be structured as a lease with a call option by the lessee.
   ► To be respected as a lease and option for federal income tax purposes, each component of the transaction should reflect arms’ length pricing and terms.
   ► Option exercise price should not be so low as to make exercise of the option too likely.
► If respected, this approach defers the sale until after death, thereby obtaining benefit of basis step-up.