February 24, 2000

The Honorable William V. Roth, Jr.
Chairman
Senate Committee on Finance
United States Senate
104 Senate Hart Office Building
Washington, D.C.  20510

Repeal of Installment Method of Accounting

Dear Chairman Roth:

As you are aware, following a proposal set forth in President Clinton’s Fiscal Year 2000 Budget Proposal, Congress repealed the installment method of tax accounting for accrual method taxpayers in the Tax Relief Act of 1999 (Title V, Subtitle C, Section 536), enacted as part of the “Ticket to Work and Work Incentives Improvement Act of 1999” (H.R. 1180). The repeal of installment sales treatment for accrual method taxpayers will adversely impact small and closely held businesses attempting to sell business assets, because they will be taxed immediately even if payments are received years later. Immediate taxation of business sellers, and its chilling effect on the marketplace, simply does not represent sound tax policy. For these and other reasons outlined below, we respectfully request that Congress reenact prior law which, for over 80 years, has permitted accrual method taxpayers to sell business assets for installment payments and defer the gain until the year cash is actually received. The position expressed in this letter has been approved by the Council of the Section of Taxation and is presented on behalf of the Section of Taxation of the American Bar Association. This position has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the American Bar Association.

Background: The 80-Year History of Installment Sales.

A brief review of the history of installment sales provides an important framework for current discussion. Generally, an accrual method taxpayer is required to recognize income when all events have occurred that fix the right to receipt and the amount can be determined with reasonable accuracy. The installment method is an exception that permits a taxpayer to defer the recognition of gain from the sale of capital assets until the year payment is actually received. The treatment given installment sales was recognized almost
from the inception of the income tax laws. Although first set forth in Treasury regulations promulgated in 1918, Congress codified the installment method of tax reporting in Section 212(d) of the 1926 Revenue Act. The policies underlying the installment method were best summarized by the Supreme Court in *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 503 (1948):

> The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the difficult and time-consuming effort of appraising the uncertain market value of installment obligations.

In the Installment Sales Revision Act of 1980, P.L. 96-471, 96th Cong., 2d Sess. (1980), Congress streamlined the rules and made them easier for taxpayers to apply. Since 1980, Congress has enacted a number of limitations on the use and benefit of installment reporting. Installment treatment is not available for dealer dispositions, it does not apply to the sales of publicly traded property, and gain is recognized if the seller monetizes the installment note through a pledge transaction. To further limit the benefit, there is an interest charge for the tax deferral to the extent a taxpayer holds installment notes in excess of $5 million.

**Reason For Repeal**

We understand there was essentially one reason cited in support of repealing the installment method for accrual method taxpayers -- the installment method is inconsistent with the accrual method because, by allowing deferral of recognition, the annual economic results of an accrual method taxpayer’s business are not properly reflected.

This reason fails to withstand careful analysis and is insufficient to overturn 80 years of consistently applied tax policy. The accrual method of tax accounting reflects a business’s economic performance by requiring the recognition of income in the year in which the income is earned and the right to receive the amount is fixed, without regard to the time payment is received. Coupled with the economic performance requirement for deductions, the accrual method matches income and deductions from operations in a manner that measures a business’s economic results each year. However, the installment exception essentially applies only to nonrecurring dispositions of business assets. While a taxpayer should be expected to pay taxes on ordinary profits earned from business operations, the nonrecurring sale of a capital asset falls into an entirely different category. The imposition of immediate taxation on the anticipated gain from the disposition of a business or substantial capital asset, such as real estate, places an unexpected and unfair burden on the business seller.
Market Effect of Repeal on Business Sales — Liquidity, Price and Deals That Will Not Be Done

Since 1918, the installment sales method has been an important rule in our Federal income tax system, because it adjusted the payment of taxes to the demands of the marketplace. In our experience representing business taxpayers, arms-length buyers and sellers have opposing views of the market and objectives in negotiating a business assets sale transaction. Buyers want the lowest price and nothing down and sellers want the highest price with cash paid in full at closing. It is against these market forces that an installment sale is finally negotiated. Often the buyer only has 10 to 20% of the purchase price in cash, but the seller is convinced the cash flow generated by the asset will enable the buyer to pay the balance over a period of years. The ability of the seller to take back an installment note for the balance of the sales price without being subject to an immediate tax liability may be the most critical issue in the transaction. In today’s marketplace, it is difficult to find a bank willing to lend to a small business buyer. Small business buyers cannot access the capital markets or draw down on their bank line of credit. Simply put, in today’s tax and economic environment, sellers take back an installment note because there are no other viable financing options available.

In addition to adversely affecting the liquidity of sellers, repeal of installment treatment will tend to depress the price paid by small business purchasers. A small business buyer is often limited in the amount it can pay for business assets. In order to increase the sales price, a business seller may increase the term of years or agree to a fixed price with an additional contingent or “earnout” amount based on future performance of the assets sold. After repeal of installment reporting for accrual taxpayers, the tax consequences of structuring such an arrangement may be devastating. As the payments are spread over an increasing number of years, so will the burden of immediate taxation in the year of sale be increased. For example, assume an accrual method taxpayer sells a building (with adjusted basis $100) for $1,100 payable $100 cash and $100 a year for 10 years. In the year of sale the taxpayer will report the full $1,000 gain and, assuming a 35% tax rate, will have an immediate tax due of $350. Since the taxpayer only received $100 cash down, the asset sale will have produced negative cash flow of $250 – meaning the taxpayer will need to find additional cash of $250 just to pay taxes.

In the case of a contingent payment sale the tax consequences could even be worse. Not only will tax be due immediately on the fixed component of the sales price, but under the original issue discount and installment reporting regulations the IRS might assert that the contingent amount must be valued and reported as taxable income in the year of sale. If this interpretation of the regulations were upheld, an installment seller would be taxed on amounts that are unknown and might never be received. Taxpayers will resist this treatment and argue that the “open transaction” doctrine applies to defer taxation on the contingent piece until actual payments are received. So, in addition to the adverse effect on price and liquidity, repeal of the installment method for this group of taxpayers raises the possibility of unnecessary complexity and increased controversy between taxpayers and the IRS.
Examples of Transactions Adversely Affected By Repeal

Passthrough entities exist, in great part, to serve the needs of the small or closely held business owner. With the numerous restrictions placed on the use of the cash method of accounting, and based on our experience with business clients, we expect that the vast majority of S corporations, business partnerships and limited liability companies taxed as partnerships use the accrual method of accounting. Accordingly, we believe many common transactions will be adversely affected by this change in law.

Employee Buyouts. It is common for a retiring owner or family group to sell to key employees. The employees typically lack the cash to complete the purchase, hence the owner must act as the lender and take back an installment note. This is a “win-win” transaction; the retiring owner is selling an illiquid asset and receiving a stream of cash (with interest) paid over a period of years, and the employees are realizing a life long dream of becoming the owners of the business. With bank financing difficult or impossible to obtain, the ability to seller-finance, without an immediate tax burden, is essential. We are aware of a number of these types of transactions that have been canceled since December 1999 due to the change in the law.

S Corporation Selling Assets. We understand that most S corporations use the accrual method of tax accounting and thus, under the change in law made last year, cannot use the installment method to sell business assets or the entire business. The entire gain is taxable in the year of sale even though the installment obligations, payable years later, are immediately passed through to the cash-basis shareholders. Although the individual cash method shareholders could sell their stock on the installment method, as pointed out in the 1999 legislative history, buyers generally want to purchase assets and will refuse to assume, directly or indirectly, the contingent liabilities that are inherent in the acquired S corporation entity. As a result both the price and liquidity of S corporation businesses have been adversely affected.

S Corporation Selling Assets to Family Under Succession Plan. For the reasons stated above repeal of the installment method will negatively impact family succession planning. Unless all of the family members involved are willing to transfer stock in the family S corporation, it will no longer be possible to sell corporate assets to younger family members using the business profits to pay the senior family members and fund their tax liability over a period of years.

S Corporation Selling Assets and Liquidating. A common plan when the owners of an S corporation wish to sell their business is the adoption of a plan of complete liquidation for the S corporation, followed by distributions of the cash and notes received from the sale to the shareholders as liquidating distributions. Under prior law, the distribution of an installment note to the shareholders in complete liquidation was not a taxable disposition and the shareholders, in effect, took the place of the S corporation for purposes of installment reporting. After the 1999 repeal of the installment method for accrual method taxpayers, whether the S corporation sells assets and liquidates or the buyer buys stock and makes a Section 338(h)(10) election, the shareholders will be required to pay tax on the sale immediately.
Accrual Method Partnerships. For partnerships, we believe the change produces unnecessary complexity and creates a trap for the unwary.

If an accrual method partnership sells its assets for an installment note, the full gain must be recognized and passed through to its partners. On the other hand, if the cash method partners sell their partnership interests, the installment rules apply and there is no gain recognition until payments are received. This rule applies even if one buyer acquires all of the interests in the partnership. This means that if the buyer desires to purchase less than all of the partnership’s assets, full gain must be recognized on the installment notes received. Moreover, often one of the partners wants to withdraw from the partnership and receive a liquidating distribution at the time of the sale. However, it is not clear that the gain realized on the sale can be specially allocated to the departing partner who actually receives the distribution, and thus taxation of the transaction will unnecessarily complicate matters for all of the partners.

We appreciate your interest in this matter. The Section would be pleased to work with the Committee and its staff on this important issue. A similar letter is being sent to Chairman Archer for his consideration.

Sincerely,

Paul J. Sax
Chair

cc: Members, Senate Finance Committee and Members House Ways and Means Committee
James D. Clark, Chief Tax Counsel, Committee on Ways and Means
Janice Mays, Democratic Chief Counsel, Committee on Ways and Means
Mark Prater, Chief Tax Counsel, Senate Committee on Finance
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Jonathan Talisman, Acting Assistant Secretary (Tax Policy), Department of the Treasury