

TAX PLANNING FOR SALES OF REAL PROPERTY

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I. ORDINARY INCOME V. CAPITAL GAIN

A. General.

1. Capital asset defined. Section 1221 provides that a capital asset includes all property held by a taxpayer, other than:
 - a. stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
 - b. property, used in his trade or business, of a character which is subject to the allowance for depreciation provided for in Section 167, or real property used in his trade or business;
 - c. self created copyrights, compositions, memoranda and similar property;
 - d. accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in 1 above; and
 - e. certain publications of the United States Government.
2. Real property. The treatment of real estate as a capital asset primarily falls under the first and second category above.
 - a. section 1231 provides further amplification of whether property (including real estate) is used in a trade or business.
 - b. under Section 1231, depreciable real property subject to the allowance for depreciation (and subject to recapture thereof under Sections 1245 and 1250) and other real property, that has been held

for more than eighteen months and used in a trade or business is afforded capital asset status. However, real estate held as inventory and/or primarily for sale will not qualify for capital asset status.

3. Computation of capital gains and losses. The computation of capital gains and losses requires the separation of gains and losses into short-term capital gains and losses and long-term capital gains and losses.
 - a. the distinction between short-term and long-term is based upon the holding period for the asset which was sold or exchanged. Short-term gains and losses arise from the sale or exchange of a capital asset held for not more than twelve months; long term gains and losses result from the sale or exchange of capital assets held for more than twelve months.
 - b. in computing adjusted gross income, noncorporate taxpayers are permitted to recognize losses from the sale or exchange of capital assets to the extent of gains from such sales or exchanges plus (if the losses exceed the gains) the lesser of \$3,000, or the excess of such losses over such gains. Individuals and other noncorporate taxpayers may carry over a net capital loss for an unlimited time until the loss is exhausted.
 - c. for corporations (except for S corporations), losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges; a net loss may not be used to offset other ordinary income. Any excess capital losses of corporations are subject to carryback and carryover provisions. A corporation may carry back a capital loss to each of the three tax years preceding the loss year. Any excess may be carried forward for five years following the loss year. However, the amount that can be carried back is limited to an amount which does not cause or increase a net operating loss in the carryback year.
4. Rates.
 - a. *noncorporate taxpayers*
 - (i) the maximum rate imposed on ordinary income of individuals, estates and trusts is 35 percent.
 - (ii) this rate may be increased for individuals by an additional 1.188 percent under the itemized deductions limitation of Section 68 and by an additional 0.67 percent under the phaseout of personal and dependent exemptions of Section 151(d)(3).

(iii) the maximum rate imposed on net capital gain of individuals, estates and trusts under Section 1(h) is 15 percent.

(iv) sales or exchanges of Section 1250 property (i.e. depreciable real property) that yield long-term capital gains will be taxed at a maximum rate of 25 percent.

b. *corporations*

(i) the maximum marginal rate imposed on ordinary income of corporations is 35 percent.

(ii) the maximum rate imposed on the net capital gains of corporations under Section 1201 is also 35 percent.

B. Property Held Primarily for Sale to Customers.

1. Overview. Section 1221 determines whether capital gain or loss is realized from the disposition of property including real estate.

a. under Section 1221(1) dispositions of property are excluded from treatment as capital transactions if they are: (1) held as inventory or stock in a trade, or (2) held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business.

b. of the two categories excluded from treatment as capital transactions under Section 1221(1), most attention has centered on the excluded category concerned with "property held primarily for sale to customers in the ordinary course of a trade or business."

2. Intent: dealer v. investor.

a. one of the most litigated areas of the tax law is whether real property is held for investment as a capital asset or whether the property is held primarily for sale to customers in the ordinary course of a trade or business and is not a capital asset.

b. since most of the debate stems from the taxpayer's "intent" in acquiring, holding, and selling the property, arbitrary definitions have been established.

c. where the facts show clearly that property is held primarily as an investment for revenue and speculation, it is classified as a capital asset, and the gain or loss from a disposition taxed as a capital gain

or loss. The word "investment" connotes either an acquisition for the purpose of receiving income produced by the property held or an acquisition for the purpose of holding the property for a considerable period of time to realize a profit on the normal increment in value through passage of time.

3. Dual purposes.

- a. It was established in *Matthews v. Comm.*, 317 F2d. 360 (6th Circ. 1963), that it is possible for the same taxpayer to hold separate parcels of real estate in different capacities, some being held for investment and others for sale in the ordinary course of business.
- b. the fact that a taxpayer has been active as a real estate "dealer", however, places a heavier burden on him to show that certain properties were not held for sale in the course of business.
- c. in *O'Donnell Patrick v. Comm.*, 31 TC 1175 (1959), a real estate builder acquired unimproved land for investment, constructed buildings thereon, sold the property and incorrectly recognized a capital gain. The Court ruled that although the taxpayer sold some unimproved lots, he had sold enough improved lots (by being a real estate builder) to be classified "in the trade or business of selling real estate property."
- d. in *Edward Butler v. Comm.*, TCM 1960-218, although the taxpayer was a real estate broker, loss upon the sale of unimproved real estate was deemed a capital loss. This result was based on the finding that the particular parcel was an isolated investment, and therefore, the property was considered not to have been held primarily for sale to customers in the ordinary course of business.

4. Multifactor test.

- a. because the inquiry into a taxpayer's motivation for owning real property is factual, the courts have developed several factors to determine if an asset is a capital asset. Although the framework varies, the multifactor test generally utilized by the courts in determining whether a taxpayer was in the trade or business of selling real estate property includes the following considerations:
 - (i) the frequency and continuity of the taxpayer's real estate transactions;
 - (ii) the purpose for which the property was acquired and held;

- (iii) the taxpayer's efforts to subdivide, develop, and improve the property;
 - (iv) the taxpayer's efforts to sell the property, including advertising and other promotional efforts to solicit buyers; including the use of agents;
 - (v) the proximity of the sale to the purchase of the property; and
 - (vi) the taxpayer's other activities and income from real estate as compared to total income.
- b. in using the multifactor test, the courts tend to simply list the factors which are applicable in a particular case and indicate whether the facts are for or against capital asset status. Commonly, one or more caveats are added such as: "no one, or group, of the test factors is controlling, . . . each case must turn on its own facts, or . . . decisions reached in earlier cases on essentially the same facts are not necessarily controlling."

C. Subdividing Property.

1. Overview. This section discusses the potential use of Section 1237 in enabling a taxpayer to subdivide and sell property without being considered a dealer.
 - a. subdivision of a tract and related sale activity are neutralized by Section 1237 as factors showing that property was held for sale in the ordinary course of business. When the conditions of Section 1237 are met, a noncorporate taxpayer is not considered a real estate dealer holding property primarily for sale merely because he has (1) subdivided a tract into lots (or parcels); and (2) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision.
 - b. this assumes, however, that there is no other substantial evidence that the real estate is held primarily for sale to customers in the ordinary course of business. Under Section 1237, only a taxpayer's subdividing and selling activities are disregarded in determining the purpose for which the taxpayer held and sold subdivided real property.

2. Section 1237.

- a. *statutory requirements.* under Section 1237, a noncorporate taxpayer will not be treated as a dealer merely because of the subdivision of a tract of land and promotional sales activities relating to it as long as:
- (i) the taxpayer was not a dealer in real estate with respect to the lot or parcel (or tract of which it is a part) in any year prior to sale and in the year of sale is not a dealer with respect to any other real property;
 - (ii) the lot or parcel has been held by the taxpayer for five years, except where acquired by inheritance or devise; and
 - (iii) the seller did not make substantial improvements which substantially enhanced the value of the lot or parcel sold.
- b. *dealer status.* the inquiry as to whether the taxpayer is a dealer in real property is the same as the common law inquiry discussed above, except the inquiry will not take into account any subdivision of the tract of land and promotional sales activity relating to it, so long as there is no other substantial evidence that the taxpayer is a dealer. Under the Regulations, the relevant inquiry is the taxpayer's intent and the existence of substantial other evidence. Substantial other evidence does not exist if only one (or none) of the following is true and may not exist if more than one of the following is true:
- (i) holding a real estate dealer's license;
 - (ii) selling other real property which was clearly investment property;
 - (iii) acting as a salesman for a real estate dealer, but without any financial interest in the business; or
 - (iv) mere ownership of other vacant property without engaging in any selling activity whatsoever with respect to it.
- c. *substantial improvements.* a taxpayer is not eligible for the special provisions of Section 1237 if the taxpayer (or certain others) makes improvements on the tract which are substantial and which substantially increase the value of the lot or parcel of real property sold.

- d. *non-substantial improvements.* temporary structures used as a field office in surveying, filling, draining, leveling and clearing operations, by the climate, are not substantial improvements.
- e. *substantial improvements.* shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewer, water, gas or electric lines are considered substantial. An improvement is not substantial if:
 - (i) the lot or parcel is held by the taxpayer for ten years or more (regardless of whether acquired by inheritance); and
 - (ii) the improvement consists of the building or installation of water, sewer, or drainage facilities or roads, including hard surface roads, curbs and gutters; and
 - (iii) the District Director with whom the taxpayer must file his return is satisfied that without such improvement, the lot sold would not have brought the prevailing local price for similar building sites; and
 - (iv) the taxpayer elects not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.
- f. *improvements by others.* improvements to the taxpayer's property by others are imputed to the taxpayer for purposes of determining whether or not the improvements are substantial under Section 1237. Improvements by the following are imputed to the taxpayer:
 - (i) the taxpayer's whole or half brother and sisters, spouse, ancestors and lineal descendants;
 - (ii) a corporation controlled by the taxpayer (50% or more direct or constructive ownership of the corporation's voting stock);
 - (iii) a partnership of which the taxpayer was a member at the time the improvements were made;
 - (iv) a lessee if the improvement takes the place of a payment of rental income;
 - (v) a federal, state or local government or political subdivision thereof, if the improvement results in an increase in the

taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets;

- (vi) any improvements made by the buyer pursuant to a contract of sale entered into between the taxpayer and the buyer.
- g. *substantial increase in value*. remove the taxpayer from the benefits of Section 1237, a substantial improvement must substantially increase the value of the lot sold.
 - (i) if the improvements increase the value of a lot by ten percent or less, such increase will not be considered substantial.
 - (ii) if the value of the lot is increased by more than 10 percent then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.
 - (iii) the increase in value to be considered is only the increase attributable to the improvement or improvements. Changes in the market price of the lots not attributable to the improvements are to be disregarded.

D. Contribution or Sale to "Related" Entities.

1. Overview. Once a taxpayer has navigated the "multifactor test" in determining whether property is held for sale to customers in the ordinary course of a trade or business, the next step is to determine how to "freeze" the character of the property's pre-transfer appreciation while retaining the ability to develop the property.
 - a. a taxpayer could sell or contribute the appreciated real estate to a related development entity (before any development) and recognize the capital gain or loss.
 - b. The new development entity would perform the development and sales activities and, therefore, any additional income recognition would be characterized as ordinary.
2. Contribution of real estate. The taxpayer may contribute property to a partnership or corporation prior to the commencement of development. However, the capital asset status inherent in the property may not be protected due to the following partnership and corporate tax laws relating to "contributed property".

- a. *partnership contributions*. the following partnership tax rules will determine whether contributing property to a controlled partnership will achieve the goal of protecting the capital gain status inherent in a parcel of investment property:
- (i) *carryover basis*. under Section 723, the partnership takes a carryover basis in the property, increased by the gain, if any, recognized by the taxpayer upon such contribution.
 - (ii) *holding period*. because the property has the same basis in the hands of the partnership as the contributing partner, the partnership's holding period for the property would include the period of time the property was held by the contributing partner.
 - (iii) *substituted basis*. the taxpayer's basis in his partnership interest is, generally, equal to his basis in the transferred property.
 - (iv) *disguised sale*. if the property is contributed to the partnership subject to a liability, an analysis of the shifting of a "qualified" or non-qualified liability must be conducted to determine if a disguised sale under Section 707(a)(2)(B) and Treas. Reg. Section 1.707-5 has been generated inadvertently.
 - (v) *deemed distributions*. if the property is contributed to the partnership subject to a liability, and the transaction was not a disguised sale, an analysis of the shift in the sharing of the liability among the partners under Section 752 must be made to minimize any gain recognized by the contributing partner on a deemed distribution of cash resulting from a reduction in his share of the partnership's liabilities.
 - (vi) *section 704(c) allocations*. under Section 704(c), the built-in gain inherent in the property on contribution must be allocated to the contributing partner under one of the three methods specified in Treas. Reg. §1.704-3.
 - (vii) *subsequent distributions*. the distribution of the contributed property to another partner or the distribution of other property to the contributing partner within five years of the original contribution to partnership may trigger the recognition of all or part of the built-in gain inherent in the property by the contributing partner.

- (viii) *subsequent transactions*. if the partnership develops the contributed property and the property becomes "property held primarily for sale to customers in the ordinary course of a trade or business," a subsequent sale will generate ordinary income. Also, the sale of a partnership interest will generate capital gain except to the extent the consideration is attributable to unrealized receivables and inventory of the partnership.

- b. *corporate contributions*. The following corporate tax rules will determine whether contributing property to a controlled corporation will achieve the goal of protecting the capital gain status inherent in a parcel of investment property.
 - (i) *carryover basis*. the corporation would take a carryover basis in the property, increased by any gain recognized by the taxpayer upon the contribution.

 - (ii) *holding period*. since the property has the same basis in the hands of the corporation as the contributor, the corporation's holding period for the property would include the period of time the property was held by the contributing shareholder.

 - (iii) *§351 transfers*. for the transfer to be a nonrecognition event to the transferor taxpayer, the transfer must qualify under Section 351, i.e., the transfer must be solely in exchange for stock and the taxpayer must be in control (80% of vote and 80% of all shares) of the corporation immediately after the exchange.

 - (iv) *substituted basis*. if the exchange qualifies under Section 351, the taxpayer's basis in the stock is, generally, equal to his basis in the transferred property. If the exchange does not qualify under Section 351, the transfer would be taxable and the taxpayer's basis in the stock would be its fair market value on the date of receipt (i.e. its cost basis).

 - (v) *excess liabilities*. if the property is transferred subject to liabilities that exceed the taxpayer's basis in the property, the taxpayer must recognize gain (treated as if from the sale or exchange of the transferred property) in an amount equal to such excess.

- (vi) *subsequent transactions.* if the corporation develops the property and becomes a developer who holds property for sale in the ordinary course of business (i.e. a "developer dealer"), a subsequent sale will generate ordinary income. The stock should remain a capital asset in the hands of the taxpayer except to the extent the corporation is a collapsible corporation under Section 341.
- 2. Sale of real estate. Rather than contribute appreciated property to a partnership or corporation, the taxpayer may choose to sell the property to the entity. If this transaction is successful, the purchasing entity would have a cost basis in the acquired property and subsequent development activities would generate ordinary income only to the extent the increased value is generated in excess of the higher basis. However, a few possible constraints exist, particularly, in the area of "related party transactions".
 - a. *section 707(b)(2).* under Section 707(b)(2), any gain on the sale or exchange of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset (as defined in Section 1221), will generate ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 50% of the capital or profits interests in the partnership.
 - (i) *attribution.* under Section 707(b)(3), the ownership of a capital or profits interest in a partnership is to be determined in accordance with the rules for constructive ownership of stock provided in Section 267(c) (other than paragraph(3)). Accordingly, the following rules apply:
 - (1) capital or profits interests owned, directly or indirectly, by or for a corporation, partnership, estate or trust are considered to be owned proportionately by or for its shareholders, partners or beneficiaries; and
 - (2) an individual is considered to own capital or profits interests owned, directly or indirectly, by or for members of his family. ("family" includes siblings, spouses, ancestors and lineal descendants).
 - (ii) *avoidance.* to avoid Section 707(b)(2), the purchasing partnership must not be, directly or indirectly, controlled by the selling partner.

- b. *section 1239.* under Section 1239, any gain on the sale of property which, in the hands of the transferee, is depreciable property will generate ordinary income if the transaction is between related persons.
- (i) *related persons.* for purposes of Section 1239, related persons include the transferor and all entities which are controlled entities with respect to the transferor and any trust in which the taxpayer (or his spouse) is a beneficiary. "Controlled entities" include:
- (1) a corporation with more than 50% of the value of the outstanding stock of which is owned, directly or indirectly, by or for such transferor;
 - (2) a partnership with more than 50% of the capital or profits interests in which is owned, directly or indirectly, by or for such transferor;
 - (3) two corporations if more than 50% of the voting power or value of the stock of which is owned, directly or indirectly, by the same person;
 - (4) a corporation and a partnership if the same persons own, directly or indirectly, more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interests in the partnership;
 - (5) two S corporations, if the same persons own, directly or indirectly, more than 50% in value of the outstanding stock of each corporation; and
 - (6) an S corporation and C corporation, if the same persons own, directly or indirectly, more than 50% in value of the outstanding stock of each corporation.

II. INSTALLMENT SALES

A. Introduction to Installment Sales.

1. Overview.

- a. *rationale.* gain that results from a sale of property must be reported in the taxable year in which the sale occurs. However, if the

transaction provides for all or part of the sales proceeds to be paid in future years, the seller is in the difficult position of paying tax without any cash.

- b. *installment sale; what.* an installment sale is defined as any disposition of property where at least one payment is received after the close of the tax year in which the disposition occurs.
- c. *benefit.* the installment method allows the taxpayer to defer the tax liability on the gain until the sales proceeds are received. The installment method is only applicable to property sold at a gain. Losses, if deductible, must be deducted in the year of sale.

2. Exceptions to installment sale reporting.

- a. *dealers.* dealers are prohibited from using the installment method. Thus, a dealer in real property must recognize the full amount of gain in the year of sale regardless of when payment is received.
 - (i) dealers should seek to either receive sufficient payments in the year of sale to cover the tax liability, or ensure that the property is sufficiently collateralized to allow for a pledge of the obligation to pay the tax liability.
 - (ii) dealers of farm property, timeshares and residential lots, however, may utilize of the installment method. Farm property is any property used or produced in the trade or business of farming, and includes such items as: fruit, animals, poultry, fields, pastures, and greenhouses to name a few.
- b. *related party sales.* if depreciable property is sold to a related party, the installment method may not be used and all income is recognized in the year of sale. Related party is defined by Section 1239 to include a person and all entities which are controlled entities with respect to such person, as well as certain trusts. The definition of a related party also includes two or more partnerships where more than 50% of the capital and profits interests are owned directly or indirectly by the same persons.
- c. *depreciation recapture.* recapture income is reported as ordinary income in the year of sale.

3. Installment method mandatory. The installment method is automatically applied if a disposition qualifies, unless the taxpayer makes a valid election by the filing due date (including extensions) of the tax return for

the year of sale. The election is made on IRS Form 6252, or by including 100% of the selling price on the tax return. Once made, the election may not be revoked without IRS consent.

4. Advantages of installment method. Use of the installment method is generally advantageous for taxpayers for a number of reasons.
 - a. the method matches the timing of tax payments with the receipt of cash proceeds.
 - b. the method spreads income recognition over several tax periods, which may produce savings for taxpayers in lower tax brackets.
 - c. the deferral of the gain creates an opportunity when tax rates are declining.
 - d. the time value of money is also an advantage whenever a deferral is present. The cash is available for the taxpayer to use until the liability comes due.
5. Electing out. Although the installment sales method is generally advantageous, valid reasons exist for taxpayers to elect out of the method.
 - a. if a taxpayer faces expiring losses or credits, then acceleration of gain is warranted.
 - b. if a taxpayer is currently in a low bracket and anticipates being in a higher bracket in future years, acceleration may be warranted.
 - c. if the taxpayer expects tax rates to rise in the future, then the taxpayer may wish to elect out of the installment method to utilize the existing lower rates.
6. Alternative minimum tax. Prior to the Revenue Act of 1987, installment sale reporting was not allowed for purposes of the alternative minimum tax. Installment sale reporting is currently allowed under the alternative minimum tax rules.

B. Calculation of Installment Sale Income.

1. Overview. As the seller collects payments from an installment sale, the payment consists of three parts; profit, return of basis, and interest. In order to trifurcate payments, the gross profit and contract price must first be computed.

- a. *gross profit.* gross profit is the amount by which the selling price exceeds the adjusted basis of the property.
- b. *selling price.* selling price, is the gross selling price without any reductions for indebtedness or selling expenses. However, if the interest provided for in the installment obligation is insufficient to satisfy the imputed interest rules or the OID rules, then the selling price is reduced to allow for such interest by the so-called "price interest recomputation rule."
- c. *adjusted basis.* adjusted basis determined in accordance with Section 1011, is generally the seller's cost increased for improvements and decreased by depreciation. For purposes of determining gross profit, the adjusted basis is increased by any commissions or selling expenses.
- d. *contract price.* contract price is the selling price reduced by any "qualifying indebtedness" which does not exceed the seller's basis.
 - (i) qualifying indebtedness is debt encumbering the property, and any other debt incurred or assumed by the purchaser incident to acquiring, holding, or operating the property. The IRS's position is that "wrap-around" mortgages fall into this category, but case law suggests otherwise.
 - (ii) the reduction for qualifying indebtedness is limited to the seller's basis in order to prevent the gross profit ratio from exceeding 100%.
 - (iii) debt incurred in contemplation of a disposition is not qualifying indebtedness.
 - (1) this rule is intended to prevent abuses of the installment sale method.
 - (2) a seller of unencumbered property, in the absence of this rule, could leverage the property with a mortgage before the sale.
 - (3) borrowing does not qualify as a taxable event, so the seller could obtain the cash up front and then defer the gain over a number of years through installment reporting.

- e. *example.* S sells property to P for a price of 100, with 30 payable in cash, assumption of a 20 mortgage, and a note for 50 (assume adequate interest on note). The basis of the property in the hands of S is 60, with a qualifying mortgage of 20.

Gross Profit Ratio = Gross Profit / Contract Price

Gross Profit = Selling Price (100) (-) Adjusted Basis (60) = 40

Contract Price = Selling Price (100) (-) Qualifying Debt (20) = 80

Gross Profit Ratio = 40 / 80 = 50%

Current Income = Payment Received (30) x Gross Profit Ratio (50%) = 15

2. Recapture income. If property which is subject to depreciation recapture is sold, then the recapture income is recognized in the year of sale and the remainder treated as installment gain.
- a. recapture income is the amount of income required to be treated as ordinary income under Section 1245 or Section 1250, and increases the adjusted basis of the property sold.
 - b. all of the recapture income is recognized in the year of sale regardless of whether payments are received.
 - c. so, a seller of real property could encounter phantom income by selling under the installment method, as the liability on the recapture could easily exceed cash payments received in the year of sale.

C. Payments Received.

1. Definition. The Regulations generally define payments to include amounts actually or constructively received in the taxable year.
- a. the amounts include cash and the fair market value of other property received, including indebtedness other than qualifying indebtedness.
 - b. if the interest portion of the payment is insufficient to satisfy the imputed interest or the OID rules, then the amount received must be allocated between principal and interest.

2. Qualifying indebtedness.

- a. qualifying indebtedness is not considered receipt of payment on an installment sale.
- b. however, qualifying indebtedness, to the extent that it exceeds basis, is considered payment in the year of sale.
- c. *example.* Assuming the same facts from the prior example, only now with a cash payment of 10, assumption of 70 mortgage, and a note for 20.

$$\text{Gross Profit} = \text{Selling Price (100)} (-) \text{Adjusted Basis (60)} = 40$$

$$\text{Contract Price} = \text{Selling Price (100)} (-) \text{Qualifying Debt (60*)} = 40$$

$$\text{Gross Profit Ratio} = 40 / 40 = 100\%$$

*The amount of debt to determine the contract price is limited to the basis; the remaining 10 is income recognized in the year of sale.

$$\text{Current Income} = (10 \times 100\%) + 10 \text{ debt in excess of basis} = 20$$

3. Wrap-around mortgages. Wrap-around mortgages may be used to prevent the current recognition of income when debt exceeds the basis of the property.

- a. if a purchaser does not assume, or take a property subject to, all of the debt encumbering that property, the remaining debt is said to be "wrapped."
- b. *example.* Assume that a property has a mortgage with a favorable interest rate of 5% . The seller may wish to finance the sale of the property with a note bearing interest at 10%, and retain the favorable mortgage. The seller may then use the proceeds from the new note to service the "wrapped" debt and keep the spread.
- c. prior to promulgation of the temporary Regulations, the Tax Court held that a wrap-around installment sale did not qualify as a debt that had been assumed for purposes of calculating the contract price and gross profit ratio. *Stonecrest Corp. v. Comm'r*, 24 TC 659 (1955).

- d. following the Installment Sales Revision Act of 1980, Regulations, which were in direct conflict with the previous rulings, were enacted and the issue was again questioned.
 - (i) the Tax Court found that the legislative history of the 1980 Act indicates that Congress reviewed the *Stonecrest* case and did not make any effort to change the tax treatment of wrap-around debt.
 - (ii) in *Professional Equities*, the Tax Court found that the Regulations were "tortuously complex" and in conflict with both the existing case law as well as the Act which they were intended to interpret. *Professional Equities, Inc. v. Comm'r*, 89 TC 165 (1987).
 - e. in *Vincent E. Webb*, 54 TCM 443 (1987), the Tax Court's position that wrap-around mortgages are not assumed indebtedness was reaffirmed, so long as the seller is not obligated to direct the installment payments to service the existing debt.
 - f. the cases that have been found against the taxpayer typically involved a conduit, such as a collection agent or a bank, so that the substance of the transaction was an assumption.
4. Readily tradable and demand notes. Indebtedness which is either payable on demand or readily tradable is deemed to be a payment in the year received.
- a. readily tradable indebtedness is defined as any debt issued by a corporation, a government, or a political subdivision if it has attached interest coupons, is in registered form, or is designed to render the debt readily tradable on an established securities market.
 - b. the Regulations further expand upon the meanings of "registered form," and "designed to be readily tradable." The regulations basically stipulate that if certain steps have been taken to ensure a market exists at issuance, then the obligation is considered "designed to be readily tradable."
 - c. convertible obligations fit into the "readily tradable" category unless the conversion occurs at a significant discount, which is defined to be less than 80% of the fair market value, or if exercise rights do not occur until after a one year holding period.
5. Security arrangements. Security arrangements for obligations may be considered payment.

- a. the mere guaranty of debt by a third party is insufficient to trigger realization.
 - b. if an escrow account is established and funded with cash or cash equivalents, then the amount in escrow is considered constructively received.
 - c. an exception exists if the escrow agreement places substantial restrictions upon the seller's right to the account, such as a non-compete agreement.
 - d. while a third party guarantee will not constitute an amount constructively received, third party debt will. This applies even if the purchaser guarantees the third party debt.
6. Related party re-sales. Special rules apply on installment sales to related parties. The related party re-sale rules fall into this category.
- a. if non-depreciable property is sold to a related party, and is subsequently resold, the remaining payments on the installment obligation are treated as being received at the time of the second sale.
 - b. the original seller's amount realized is equal to the excess of (i) the lesser of the total amount realized from the second disposition or the total contract price of the first disposition over (ii) the total payments received in the current and all previous years on the first disposition.
 - c. *example*. Assume S sells property to R for 200, with 100 paid in year one and 100 to be paid in year 2. In year 2, before R pays the remaining 100 to S, R resells the property to P for 80.

S recognizes 80 as a payment received [80 is the lesser of amount realized from second disposition (80) and the contract price of the first disposition less previous payments (200 (-) 100=100].

If R had resold the property for 120, then S would only recognize 100.
 - d. a related party is defined to be anyone to whom stock would attributed under Section 318(a) or who bears a relationship under 267(b).

D. Contingent Payment Sales (Sales with "*Equity Kickers*") .

1. Overview. A contingent payment sale is a disposition of property in which the aggregate selling price cannot be determined by the close of the tax year in which the disposition occurs.
 - a. since the total gain on a contingency sale is not determinable, the regulations allocate basis over the life of the payment period.
 - b. the Regulations prescribe methods for three kinds of contingencies; sales with a fixed payment period, sales with a maximum selling price, and sales with neither a fixed payment period nor a maximum selling price.
 - c. caution should be taken when approaching a contingent installment arrangement, however, as the methods prescribed are not available if the structure could be viewed as a joint venture, partnership, or an equity interest in a corporation.
2. Sales with fixed payment period. Sales with a fixed payment period are sales where the maximum selling price is indeterminable, but the period over which payments are to be received is fixed.
 - a. the Regulations allocate the seller's basis equally over the tax years in which payments may be received.
 - b. if during any of these years, no payments are received, or the amounts received are less than the basis allocated to that tax year, then no loss is allowable unless it is the last year of the obligation, or it can be demonstrated that the obligation is worthless.
 - c. an exception to this method of equal annual increments may apply if the amount of the contingent payment is based on a specified formula. For instance, if 20% is to be paid in the first two years and 30% in the last two, then basis could be allocated using similar percentages.
3. Sales with stated maximum selling price. Sales with a maximum selling price are sales where at the end of year in which the disposition occurs, the maximum selling price can be determined.
 - a. the maximum selling price will be the maximum price payable if all contingencies are met in the seller's favor.
 - b. using this method, the seller applies the initially computed gross profit percentage until an event occurs that requires the maximum

amount to be reduced. The seller would then recompute the gross profit percentage.

- c. if the adjusted maximum selling price is less than the unrecovered basis, then the seller is entitled to deduct the loss.

4. Sales with no fixed selling price or payment period. Sales with neither a fixed payment period nor a maximum selling price begin to resemble equity interests rather than installment obligations.

- a. the regulations state that this type of arrangement "will be closely scrutinized."
- b. if a sale has occurred, then the basis will be allocated equally over a fifteen year period.
- c. unlike sales with a fixed payment period, if payments received in any year are less than the allocated basis, the unused basis must be spread evenly across the remaining years of the original fifteen year period.
- d. if after fifteen years, basis still remains, then it is carried forward until used or the obligation becomes worthless and can then be deducted.
- e. exceptions to this method may apply if the seller can demonstrate that the method would substantially and inappropriately defer the basis recovery.

5. Alternative methods of basis recovery. Alternative methods of basis recovery may be applied if the normal basis allocation rules do not consider the nature of the property. A taxpayer may elect to use the income forecast method or can request a ruling from the IRS for an alternative method if the seller's income would otherwise be distorted.

6. Interest on contingent debt.

- a. *overview.* installment obligations with contingent payments will generally be considered contingent debt under Section 1274. Accordingly, the Regulations provide that the "Discounted Payment Method" be applied in determining what portion of payment is principal and what portion is interest. The Discounted Payment Method essentially computes principal by discounting payments back using the AFR, with the remainder being interest.

- b. *contingent debt.* contingent debt is defined as debt with one or more contingent payments.
 - (i) the Regulations, however, provide no definition for determining when a payment is contingent.
 - (ii) the Regulations do provide some additional guidance as to what qualifies as contingent debt, by telling us what contingent debt is not.
 - (iii) debt instruments with fixed interest rates including OID calculations, variable interest rates as defined in Reg. § 1.1275-5, conversions features, or incidental contingencies are not considered contingent debt.

- c. *discounted payment method.* contingent debt payments for non-traded property are subject to the Discounted Payment Method.
 - (i) under this method, payments are bifurcated into two parts: noncontingent payments and contingent payments.
 - (ii) noncontingent payments are treated as a separate debt instrument, with an issue price equal to the issue price of the overall instrument, and interest computed under the OID rules. For the noncontingent portion, both parties will accrue interest on the debt.
 - (iii) contingent payments are not accounted for until considered payable. Once this determination is made, the payment is discounted back to the issue date with the discounted value representing principal and the remainder representing interest. The interest rate used to discount the payment is the greater of the stated rate of interest or the AFR in effect on the issue date of the overall debt instrument.

- d. *example.* S receives a contingent payment of 500 from P two years after the issuance of the debt instrument. Assume the AFR at issuance was 10% .

The payment is discounted back two years using a rate of 10%, yielding a present value at issuance of 413.

The remaining 87 is interest.

E. Interest and Pledge Rules of §453A

1. Overview. The Revenue Act of 1987 placed certain restrictions on the use of installment sales.
 - a. the restrictions require an interest "toll" charge to be paid on certain tax liabilities deferred under installment reporting.
 - b. restrictions were also placed on the ability to pledge an installment obligation to secure a debt.
2. Applicability of the rules. The interest and pledge rules apply to installment obligations arising from dispositions with sales prices exceeding \$150,000. These obligations are typically referred to as "453A obligations."
 - a. the interest payment, however, has a special rule exempting obligations which, at the close of the tax year, have face amounts less than \$5,000,000.
 - (i) in applying this test to pass-through entities, the \$5,000,000 threshold is viewed at the partner (or shareholder) level, and not the entity level.
 - (ii) consolidated groups can be viewed at employer levels under Section 52(a) and (b) when applying the threshold.
 - (iii) obligations otherwise subject to Section 453A, but exempt under this provision, are still subject to the pledging rules.
 - b. an exception to the rules of Section 453A, both the interest and pledging rules, exists for personal use and farm property.
 - c. residential lots and timeshares, which are subject to similar interest rules under Section 453(l)(3), are exempted from the interest rules of Section 453A, but not the pledging rules.
3. Interest "toll" charge. The computation of the interest "toll" charge due on each Section 453A obligation is represented by the following equation:
$$\text{Interest Charge} = (\text{Applicable Percentage}) \times (\text{Deferred Tax Liability}) \times (\text{Underpayment Rate under Section 6621(a)(2)})$$
 - a. *applicable percentage* is calculated by dividing the excess of the aggregate face amount over the \$5,000,000 threshold at the close

of the tax year, by the aggregate face amount at the close of the tax year.

- b. *deferred tax liability* is defined as the product of the unrecognized gain on an installment obligation as of the close of the tax year and the maximum tax rate.
- c. *underpayment rate* under Section 6621(a)(2) for the month within which the tax year ends is used as the interest rate to compute the "toll" charge.
- d. *example.* S, a nondealer, sells real property to P for \$20 million with \$5 million down and an installment note for \$15 million bearing adequate interest. At the close of the tax year \$10 million of the note remains outstanding. S had a basis of \$10 million in the property. S is a corporation with a maximum rate of 35%, and assume the underpayment rate in effect is 10% .

$$\text{Applicable Percentage} = (10,000,000 (-) 5,000,000) / 10,000,000 = 50\%$$

$$\text{Deferred Tax Liability} = (\text{Gross Profit \%} \times 10,000,000) \times (35\%) = (50\% \times 10,000,000) \times 35\% = 1,750,000$$

$$\text{Interest Charge} = (50\%) \times (1,750,000 \times 10\%) = \$87,500$$

- e. taxpayers required to pay the interest treat the expense similar to interest on the underpayment of tax.
 - (i) this means that the interest is "personal interest" under Section 163(h).
 - (ii) no deduction is allowed to a taxpayer, other than a corporation, for personal interest.
4. Pledging rules. Pledging of an obligation results in gain recognition on the installment obligation.
- a. the net proceeds of any debt secured by an installment obligation are treated as payment received on the installment obligation, thus triggering the gain.
 - b. the payments are considered received on the latter of the actual receipt of the net proceeds, or the time the debt becomes secured.

- c. the amount considered received is limited, however, to the total contract price less any payments previously treated as received. As payments are subsequently received on the installment note, no income is recognized unless and until the total payments received exceed the amounts included as a payment as a result of the pledge of the note.
- d. similar to the rules which disallow debt considered to be in contemplation of a disposition from being classified as qualifying indebtedness, this restriction is imposed to prevent taxpayers from obtaining the cash proceeds, directly or indirectly, from the installment note without having to simultaneously recognize income.

F. Dispositions of Installment Obligations.

- 1. Gain or loss recognized. In general, if an installment obligation is sold, or otherwise disposed of, then gain or loss is to be recognized by the seller.
 - a. the amount of gain or loss recognized is the difference between the basis of the obligation and either the amount realized or the fair market value of the obligation at the time of disposition.
 - b. the amount realized is used to calculate the gain or loss when a sale or exchange has occurred, or if the obligation is settled at other than face value. The fair market value at the time of disposition is used when the obligation has been disposed of other than by sale or exchange.
 - c. the basis of the obligation is considered to be the excess of the face value of the obligation over the amount equal to the income which would be returnable if the debt were satisfied. The basis is thus equal to the product of the unpaid balance of the installment obligation and the gross profit percentage.
 - d. *example.* Assume S sold property to P in the prior year for \$10,000,000 with \$1,000,000 down and an installment note for \$9,000,000. S had a basis of \$5,000,000 in the property. S had received no additional payments on the note before subsequently disposing of the obligation for \$8,000,000.

S's original gross profit percentage is 50% (\$5,000,000 gross profit divided by \$10,000,000 contract price).

S has \$4,500,000 of unrecognized profit at the time of the disposition (\$9,000,000 times 50%).

The face amount of the note less the unrecognized profit becomes S's basis in the note (\$9,000,000 (-) \$4,500,000 = \$4,500,000).

Therefore, S will recognize a gain of \$3,500,000 on the disposition (\$8,000,000 realized less basis of \$4,500,000).

- e. the character of the gain or loss on the disposition of the installment obligation is determined by the character of the property sold which generated the obligation. Thus if the property originally sold gave rise to a capital gain, then the gain or loss on the disposition of the note is also a capital gain.

2. Debt modification as a disposition. The critical issue concerning the rules of Section 453B is what constitutes a taxable disposition of an installment obligation?

- a. in general, a disposition is considered to occur "when the rights accruing to the seller under an installment sale either disappear or are materially disposed of or altered so that the need for postponing the recognition of gain otherwise realized ceases."
- b. the definition of "materially altered" remains somewhat unresolved.
- c. *impact of Cottage Savings.* Further controversy has emerged surrounding debt modification following the Supreme Court's opinion in *Cottage Savings Ass'n v. Commr*, 499 U.S. 554 (1991).
 - (i) the issue in *Cottage Savings* was whether tax losses were realized upon the exchange of mortgage participation interests for substantially identical mortgage participation interests. The exchange was recorded as a sale and purchase of the interests and were made with the same financial institution. The Supreme Court found in favor of the taxpayer, citing material differences between the mortgage participation interests. The differences were due to the fact that they were secured by different homes and different obligors, thereby embodying legally distinct entitlements under Section 1001.
 - (ii) as a result of the ambiguity left in *Cottage Savings* wake, the Treasury issued new regulations under Section 1001, which deal specifically with debt instrument modification. These regulations were finalized in 1996, and while they do

not directly address installment obligations, they do raise questions regarding the "material alteration" standard.

- (iii) however, the application of the debt modification regulations under Section 1001 to Section 453B installment dispositions is still unclear. The preamble to the Final Regulations states that a modification of a debt instrument under §1001 does not determine whether a disposition has occurred under Section 453B.

3. Other taxable dispositions. The question of whether a taxable disposition has occurred in transactions not involving a debt modification is answered much easier. Some common examples include:

- a. the sale, exchange, or even gift of an installment obligation is a taxable disposition.
- b. the cancellation or unenforceability of the note is a taxable disposition.
- c. the conversion of an installment obligation into stock is a taxable disposition.
- d. in general, distributions constitute taxable dispositions, although certain exceptions apply. Transfers pursuant to a tax-free transaction, such as a Section 351 (or Section 721) contribution or a Section 731 distribution, are not taxable dispositions.