Deferred Payment Sales: The Installment Sale Provisions Re-examined

Ellsworth W. Jones

The gain from a sale of real or personal property is usually subject to an income tax in the year of sale. This is acceptable to taxpayers when the entire sale price is received in cash and the transaction is closed.[1] Frequently, however, the sale is made on deferred payment terms, *i.e.*, the buyer makes a cash down payment and also obligates himself to pay the balance of the purchase price over a period of time. If the transaction is considered closed for tax purposes, the seller is forced to pay income tax on unreceived profit. There are three methods of reporting gain to avoid this result. They are: (1) the deferred payment method, (2) the cost recovery method, and (3) the installment reporting method.

Deferred Payment: The deferred payment method can be used if the buyer's future payment obligation has a fair market value less than its face value.[2] The taxable

[1] It is possible to defer receipt of the purchase price through certain escrow arrangements. However, the seller then encounters the doctrine of constructive receipt. Treas. Reg. 1.451-2(a). Under this doctrine, income is realized when the contract terms are complete and the seller is entitled to the down payment if he desires. Williams v. United States, 219 F.2d 523 (5th Cir. 1955); or when the original agreement is for a cash sale but is later changed to fit the installment reporting requirement. Rhodes v. United States, 243 F. Supp. 894 (W.D.S.C. 1965). There is no constructive receipt, however, when an escrow arrangement having a valid business purpose postpones transfer until some of the contract provisions are fulfilled. Harold W. Johnston, 14 T.C. 560 (1950).

[2] For a cash basis seller, gain or loss is immediately realized when the buyer's note or other obligation has a fair market value equivalent to cash. Treas. Reg. 1.466-1(c)(1)(i); Whitlow v. Commissioner, 82 F.2d 569 (8th Cir. 1936); Teck Hobbs, 26 B.T.A. 241 (1932).

For an accrual basis seller, the note or other obligation must be accrued when received if it is an unconditional obligation to pay a fixed amount, and the other prerequisites are present. Treas. Regs. 1.451-1 and 2; Treas. Reg. 1.446-1(c)(1)(i). But if collectibility is questionable this may be reflected in computing the amount accruable. Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

gain is the difference between the fair market value reported and the basis of the property.[3] The undesirability of this method (in addition to proving fair market value) is that at the time the difference between fair market value and property basis is actually paid, it is taxed as ordinary income, irrespective of the character of the property sold. Thus, any possible capital gain is automatically converted into ordinary income.

COST RECOVERY: The second method depends on a cost-recovery analysis. If the buyer's obligation for future payments has *no* fair market value, the seller is not taxed until he recovers the basis of the property.[4] After recovery of basis, the payments are taxed as ordinary income or capital gain, depending on the specific character of the property sold. Even though capital gain is not lost at this point, there is still the difficulty of proving a total lack of fair market value. The Internal Revenue Service maintains that the absence of fair market value is extremely rare.[5]

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[3] In this case the gain, if any, is immediately realized and the transaction is closed. E.M. Webb, 30 T.C. 1202 (1958). If there are later payments in excess of the fair market value reported, they are prorated in the ratio that the value at receipt bears to the face amount. A. B. Culbertson, 14 T.C. 1421 (1950); Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962).

[4] Commissioner v. Logan, 283 U.S. 404 (1931).

[5] Rev. Rul. 58-402, 1958-2 CUM. BULL. 15; Treas. Reg. 1.453-6(a)(2). The courts have not been as harsh, however, and have found a buyer's obligations without market value where they are unsalable or subject to substantial contingencies. There is no fair market value where nothing is present except an unsecured contract. N. J. Ennis, 17 T.C. 465 (1951); C. W. Titus Inc., 33 B.T.A. 928 (1936), *cert. denied,* 326 U.S. 773 (1945); where non-negotiable promissory notes are received. Dudley T. Humphrey, 32 B.T.A. 280 (1935); where notes secured by a second mortgage could not be sold except at a discount and with endorsement. Joliet Norfolk Farm Corp., 8 B.T.A. 824 (1927); or where the notes were not acceptable as collateral. Revlin Corp., 19 B.T.A. 1112 (1930).

Some obligations have been so contingent that they preclude any valuation. These include: payment only out of future earnings. United States v. Yerger, 55 F. Supp. 521 (E.D.P.A. 1944); payments only out of future royalties. Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); and obligations requiring payments to be escrowed until sufficient profits were present. Big Lake Oil Co. v. Commissioner, 95 F.2d 573 (3rd Cir. 1938), *cert. denied,* 307 U.S. 638 (1939); until the equipment was tested. Webb Press Co., Ltd., 3 B.T.A. 247 (1925); or as a guarantee against possible losses or contingent liabilities. Marion H. McArdle, 11 T.C. 961 (1949).

INSTALLMENT REPORTING: Use of the installment method provisions is not mandatory; a taxpayer is free to use them or not, as he wishes. However, many of the problems inherent in the other deferred payment methods of reporting gain can be avoided by using the installment reporting method. Section 453, Internal Revenue Code of 1954 provides tax relief for certain deferred payment sales by allowing taxpayers an election (if specified requirements are met) to prorate their profit during the time installment payments are received. The formula used to prorate taxable profit is:

$$\frac{\text{Gross Profit Realized}}{\text{Total Contract Price}} = \text{Percentage Gain} \times \text{Payments During Year} = \text{Profit to Report}$$

There is no specific requirement for periodic or regular installments, and it is not necessary that any payment be received in the year of sale. However, there must be payments in at least two taxable years; otherwise, section 453 may not be utilized.[6]

The effect of the installment method is to spread the tax on gain over the period of the years of collection. Thus, there is usually money available to pay the income tax due. For example, if property is sold for $4,000, payable in annual installments of $1,000, and the gross profit (selling price less basis) is $1,000, or 25 per cent of the total selling price, then only 25 per cent, or $250, of each $1,000 annual payment is taxable. Although the gain might be reported under the installment provisions, or either of the other two methods, it may not be advisable to do so. It might be better to report the full gain in the year of sale to offset capital losses.

GENERAL RULES FOR APPLICATION OF INSTALLMENT REPORTING

The requirements under the installment method are especially restrictive and exacting, hence a specific election

[6] E. M. Funsten, 44 B.T.A. 1166 (1941).

must be made. Its operation depends on the particular facts in each case and certain terms acquire a special meaning.

AN ELECTION IS NECESSARY: The reporting of gain under the installment method does not apply unless a specific election is made. The mechanics of electing vary, depending on the taxpayer.

A dealer election must be made on an income tax return at or before the time specified (including extensions) for filing.[7]

An election by a partnership must be made on Form 1065. If this is not done, the partners cannot make a later election on their individual returns.[8] Once the partnership elects, each partner must thereafter follow the installment reporting method on his individual tax returns. Presumably, a similar consistency is also required from the shareholders of a corporation who make an income reporting election according to the provisions of Sub-Chapter S, Internal Revenue Code of 1954.

The rules are somewhat more complicated for casual sales of real or personal property. Originally, the Internal Revenue Service maintained that the election was forfeited unless made in the taxable year of sale by including the gross profit computation on the return, even though no payments were received.[9] However, I.R.S. relented to an extent when faced with a rash of decisions holding against its position.[10] I.R.S. currently allows a taxpayer, who in good faith fails to elect in a timely-filed original return for the year of sale, to make a valid election under any of the following circumstances:[11]

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7 Treas. Reg. 1.453-8(a)(1).

8 John G. Scherf, Jr., 20 T.C. 346 (1953).

9 Rev. Rul. 93, 1953-1 CUM. BULL. 82; Ackerman v. United States, 318 F.2d 402 (10th Cir. 1963).

10 John P. Reaver, 42 T.C. 72 (1964); Robert L. Griffin, 24 CCH Tax Ct. Mem. 467, P-H Tax Ct. Mem. ¶ 65,091 (1965); F. E. McGillick, 42 T.C. 1059 (1965); District Director v. Mayer, 345 F.2d 476 (8th Cir. 1965); John F. Bayley, 35 T.C. 288 (1960).

11 Rev. Rul. 65-297, 1965-50 INT. REV. BULL. 26; The form of the sale can not be altered after it is consummated so as to qualify for the election. Rev. Rul. 56-20, 1956-1 CUM. BULL. 197.

A. If the sale took place in a taxable year ending before December 18, 1965 (the effective date of the present regulations), the election must have been made on the return for the year the first payment was received.

B. If an election is made on an amended return, the year of sale is not beyond the bar of the statute of limitations or other rules of law, and no other inconsistent election has been made.[12]

C. If the election is made on a delinquent return for the year of sale.

A taxpayer who elects should attach a schedule to his income tax return showing the gross profit computation, including details of cost and additions, selling price, mortgages involved, expenses of sale, recognized gain in the year of sale, and the terms of the sale.[13]

WHO MAY ELECT: The installment method of reporting gain is available to the following taxpayers:

A. Dealers in personal property regularly selling on the installment plan;

B. Those selling real property, if payments received in

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[12] A taxpayer is not bound by a good faith election of an unacceptable method of reporting the gain, *e.g.*, the cost-recovery method, if the transaction was fully disclosed on the return in the year of sale. Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965) (distinguishing between the types of elections).

It is quite clear, on the other hand, that a valid election to use the installment method, or one of the other deferred payment methods, is binding once made and cannot be revoked by filing an amended return. Pacific Nat'l Co. v. Commissioner, 304 U.S. 191 (1938); Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955); E. P. Lamberth's Estate, 31 T.C. 302 (1958).

An election made after the due date (including extensions) for filing the return for the year of sale will not be recognized as valid if the assessment or collection of any tax owed on the sale under the installment method is prevented by the statute of limitations or any other rule of law. Collector v. Norris, 72 F.2d 753 (10th Cir. 1934); Rev. Rul. 65-297, 1965-50 INT. REV. BULL. 26.

[13] Treas. Reg. 1.453-8(b); Hornberger v. Commissioner, 289 F.2d 602 (5th Cir. 1961).

Rev. Rul. 56-396, 1956-2 CUM. BULL. 298, allows the election on an amended return where section 1034 (dealing with gain from the sale of a residence) was elected on a timely-filed original return—but the residence was not replaced within the required time. See also John F. Bayley, 35 T.C. 288 (1960), accepting the election on an amended Tax Court petition.

the year of sale are not more than 30 per cent of the selling price; or

C. Those making a *casual* sale of personal property for a price exceeding $1,000, if payments received in the year of sale are not more than 30 per cent of the selling price.

DEALER STATUS: The requirements and effect of the installment method are somewhat different for dealers and non-dealers.

A dealer is one who regularly sells personal property on the installment plan;[14] no minimum percentage of installment sales is required. However, the principal advantage of acquiring dealer status would result if the personalty is sold for less than $1,000.

The number and frequency of sales, and a general retailer status will usually govern.[15] Sales from inventory may be reported on the installment method once dealer status is established.[16] Of course, dealer status would also prevent characterization of inventory proceeds as capital gain.

Acquisition of dealer status may be affected by the nature of the property sold. For example, a seller of completed houses, entirely constructed in the seller's factory, is a dealer in personal property. However, a seller who constructs custom-built houses on the land of another is not a dealer even though state law treats the houses as the seller's chattels until they are completed.[17]

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14 Treas. Reg. 1.453-2.

15 Lenox Clothes Shops, Inc., 45 B.T.A. 1122 (1942).

16 I.T. 2063, III-2 CUM. BULL. 108; INT. REV. CODE of 1954, § 453(b)(1)(B).

17 G.C.M. 27169, 1952-2 CUM. BULL. 120; Rev. Rul. 59-250, 1959-2 CUM. BULL. 134. There is some doubt about this position, however, depending on the type of houses involved. A recent case, W. W. Pope, 24 CCH Tax Ct. Mem. 1046, P-H Tax Ct. Mem. ¶ 65,211 (1965), involved a construction contractor who built houses on land owned by his customers. He gave them a choice among six model homes, each with a basic price; but this price could vary, according to the customer's personal choice of materials, appliances, and other additions. Although the contractor precut some of the lumber used, he subcontracted slab, framing, siding, trim, and other parts of the construction process. The Internal Revenue Service contended that he dealt primarily in personal services, not personal property. Thus, he was not a dealer so he could not report income from his house sales on the installment basis. The court did not agree with I.R.S.

Although the houses were constructed on the customers' land, the court

The provisions specifically applicable to dealers are complex, extensive, and outside the scope of this article. Those faced with a dealer situation should carefully study the law, regulations, and decided cases. Special rules are applied.[18]

CASUAL SALES OF PERSONALTY: A casual sale of personal property must be a single transaction for a selling price of more than $1,000 and the purchase payments received in the year of sale cannot exceed 30 per cent of the total selling price. Although the installment method for reporting gain does not have to be elected for all casual sale transactions during the year, (it may be used for a single transaction) the proceeds from several sales cannot be combined to report a price in excess of $1,000.[19]

Personal property in this context includes the sale of the writings of a non-professional author and the sale of an exclusive distributorship agreement with a foreign manufacturer,[20] but it does not include the sale of options received as compensation for services.[21] If gain results from the sale of this type of property, it can be reported in the manner previously discussed, *i.e.,* the amount of profit to be reported is calculated by measuring the gain percentage of the sale against the payments received during the year.

ADDITIONAL RULES FOR APPLICATION OF INSTALLMENT REPORTING

If the particular type of property involved qualifies,

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believed that the taxpayer's operation was " . . . a sale and delivery of personal property, to wit, a dwelling house." Further, taxpayer held himself out as a dealer selling his own variety of dwelling houses; he was not a building contractor offering services in building custom-built homes to suit the "whims and fancies" of his customers. At the least, this case indicates a middle ground between a seller of prefabricated houses and a builder of custom-built homes. At the most, it indicates that a builder can practically custom-build houses without forfeiting dealer status, and still use the installment method of reporting his income.

18 See INT. REV. CODE of 1954, §§ 453(a), 453(c), 453(e), and the regulations thereunder.

19 E. P. Greenwood, 34 B.T.A. 1209 (1936).

20 Rev. Rul. 234, 1953-2 CUM. BULL. 29; Rev. Rul. 55-374, 1955-1 CUM. BULL. 370.

21 Charles E. Sorenson, 22 T.C. 321 (1954).

installment reporting of the gain may be applied to sales of real estate and casual sales of personal property for more than $1,000. It cannot be used for reporting losses, nor for inventory sales unless the dealer provisions apply.[22] It may be used for only one sale regardless of the reporting method elected for other transactions during the year; and its use does not change the nature of the profit from the property sold.

If the property is a capital asset or is treated as one,[23] the profit reported remains capital gain; if the property is a type that produces ordinary income, the profit remains ordinary income. In determining which it is, the law in effect in the year the profit payments are received controls —not the law in effect during the year of sale.[24] The type of capital gain is determined by the length of the period from the date of acquisition until the date of sale. This factor is not influenced by the time fixed for seller receipt of installment payments.

In some instances the sale of depreciable real or personal property will bring into play the so-called depreciation recapture rules.[25] These rules in general provide that any capital gain from a sale might be considered ordinary income, depending on the type of property sold and the amount of depreciation taken as an income tax deduction prior to the sale. Although capital gain is ordinary income under the recapture rules, it may still be reported under the installment method, if the other qualifying requirements of installment reporting are present in the transaction.

The entire gain from the transaction does not have to be

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22 I.T. 2063, III-2 CUM. BULL. 108; INT. REV. CODE of 1954, § 453(b)(1)(B).

23 INT. REV. CODE of 1954, §§ 1221, 1231.

24 Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938); Zola Klien, 42 T.C. 1000 (1964).

25 INT. REV. CODE of 1954, § 1245 applies to dispositions of certain depreciable personal property in taxable years beginning after December 31, 1962. INT. REV. CODE of 1954, § 1250 applies to gains from disposition of depreciable real property (including leasehold interests) after December 31, 1963. The rules for section 1250 do not apply to the gain from the sale of land. Therefore, when depreciable real property is sold it is necessary to separate the gain on the land from the gain on the depreciable buildings or improvements.

taxable for an application of the installment provisions. A taxpayer can have a combination of a like-kind exchange of property and cash under the provisions of section 1031, Internal Revenue Code of 1954.[26]

The same principles also apply to a gain on residence sales, even though the purchase of a new residence results in the partial non-recognition of gain under section 1034, Internal Revenue Code of 1954.[27] If the installment sale requirements are met, the amount of each payment to be reported as income is calculated from the recognized, not the actual, gain. For example, in 1966, taxpayers sell their residence, which has a basis of $8,000, for a contract price of $12,000 and replace it in the same year with another residence costing $10,000. Under section 1034, the excess of the $12,000 sale price (adjusted price for this purpose) over the cost of the new residence, or $2,000, is the recognized gain. The sale agreement further provides for a down payment of $3,000 in 1966 (assume less than 30 per cent of the selling price) and the balance to be paid in $1,500 annual installments. Hence, the recognized gain of $2,000 would be reported on the installment basis for the first year as follows:

$$\frac{\$2{,}000 \text{ (recognized gain)}}{\$12{,}000 \text{ (total contract price)}} \times \$3{,}000 \text{ (down payment)} = \$500.00;$$

and in the following years,

$$\frac{\$2{,}000}{\$12{,}000} \times \$1{,}500 \text{ (annual installment payments)} = \$250.00.$$

The Specific Requirements Considered

To determine whether or not installment reporting can

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26 Rev. Rul. 65-155, 1965-23 Int. Rev. Bull. 15; Int. Rev. Code of 1954, § 1031 allows property held for productive use in a trade or business or held for investment purposes to be exchanged for like-kind property without any recognition of gain.

27 Rev. Rul. 75, 1953-1 Cum. Bull. 83; Int. Rev. Code of 1954, § 1034 allows the gain from the sale of a residence to avoid taxation under certain conditions if a new residence is purchased.

be used and what part of the gain must be included in taxable income each year, four factors of the sale must be examined:

1. the selling price,
2. the payments in the year of sale,
3. the gross profit realized, and
4. the total contract price.

The first two factors aid in deciding whether the election can be made; the remaining two factors determine the percentage of gain taxed each year. Selling expenses are deductible only in computing the gross profit realized. However, selling expenses do not reduce the amount of payments received, the amount of the total contract price, or the amount of the selling price.[28]

THE SELLING PRICE: A taxpayer may use the installment method of reporting gain if the payments received in the year of sale do not exceed 30 per cent of the selling price. This requirement is obviously met if no payments are received;[29] nonetheless, the selling price must still be analyzed. Selling price includes all cash, notes, and other property received, plus any mortgages or liens against the property, whether or not they are specifically included in the sale price stated in the deed or contract.[30]

For example, a taxpayer sells property subject to a $10,000 mortgage for $30,000 in cash installments over a 10-year period, with the buyer assuming the mortgage. The $10,000 mortgage is added to the total $30,000 cash payments to be paid, resulting in a $40,000 selling price for application of the 30 per cent test. When property other than cash is received in the sale, its fair market value (not face value) is the amount included in the selling price.[31]

Computation of selling price can also be affected by the mode specified for interest payment. If the sales contract

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28 Treas. Regs. 1.453-1(b); 1.453-4(c).

29 Treas. Reg. 1.453-1(c); Gilbert v. Commissioner, 241 F.2d 491 (9th Cir. 1957).

30 Treas. Reg. 1.453-4(c). This can also include accrued taxes, interest, and other liens or debts assumed by the purchaser. Katherine H. Watson, 20 B.T.A. 270 (1930).

31 Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962).

does not have a provision for interest, or if there is a provision for simple interest at less than 4 per cent per annum, so that Internal Revenue Code of 1954, § 483 (1964) applies, then the unstated interest amount determined under that section will not be included in the selling price. Hence, the selling price is decreased.[32] However, if the interest is considered adequate under section 483, the amount of interest contained in each payment is not counted in applying the 30 per cent test for payments received in the year of sale; only payments on principal are considered.

Like-kind exchanges under section 1031 can have taxable gain and this gain can be reported on the installment basis. The determination of selling price in section 1031 transactions requires special consideration. For example, in *Clinton H. Mitchell*,[33] the taxpayers exchanged improved real property valued at $148,000 but subject to an $18,000 indebtedness (net value $130,000) for a $247,000 motel subject to an $80,000 indebtedness (net value $167,000). To balance out the transaction, the taxpayers gave a $105,000 note to the other party and received a $69,000 installment note in return. The $69,000 note was the recognized gain under section 1031. The taxpayers attempted to use the installment reporting method. To determine the taxpayers' selling price on the exchange (for application of the 30 per cent rule), the court included: the $167,000 net value of the motel received; the $18,000 value of their mortgage assumed by the other party; and the $69,000 note the tax-

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[32] INT. REV. CODE of 1954, § 483 (1964) provides that in certain deferred payment contracts for the sale or exchange of property, interest income is imposed on some installment payments if the contract specifies no interest or if the interest allowed is unrealistically low. If this section is applicable, the seller reports part of each installment payment as interest income. The buyer does not include it in his basis, but deducts it as an interest expense. This could disqualify a sale from installment reporting. The installment method of reporting gain applies only if the payments in the year of sale do not exceed 30 per cent of the selling price. If the interest imputed under section 483 is subtracted from the selling price, the selling price is reduced. Then the initial payments in the year of sale might exceed 30 per cent of this reduced sales price. Treas. Regs. 1.483-1; 1.483-2.

[33] 42 T.C. 953 (1964).

payers received. The result was a total selling price of $254,000.[34]

THE THIRTY PER CENT RULE: The 30 per cent limitation applies to the selling price as it is finally determined. The sale of each parcel or lot in a subdivided tract of land must be treated as a separate transaction. The gain or loss is computed accordingly.[35]

Apparently, it is not permissible to divide a lump-sum down payment received from the sale of a going business, or received from the sale of combined real and personal property in order to comply with the 30 per cent requirement.[36] However, there appears to be no reason why these distinct-asset sales cannot be divided into two contracts if the total payments to the seller in the year of sale will exceed 30 per cent of the selling price.

For example, in a sale of a multi-asset business, the 30 per cent test appeared to present a problem. One of the assets of the business was a liquor license which, by state law, could not be sold for less than a 40 per cent down payment. The problem was solved by allocating 40 per cent of the selling price of the liquor license as the down payment for the license. The installment method did not apply to that portion of the sale representing the license even though the total down payment for the entire business did not exceed 30 per cent. However, the remainder of the sale came within the installment reporting requirements.[37]

The same principles could be carried over into the sale of an entire business by dividing the transaction into two separate contracts: one contract for the cash sale of the equip-

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[34] On the issue of payments in the year of sale, the court in *Mitchell* excluded the $69,000 note received, but included the motel's net value of $167,000 and cash payments of $3,000 received on the $69,000 installment note during the year of sale. The result was a payment of $170,000 received in the year of sale. Because the year of sale payment exceeded 30 per cent of the selling price, the $69,000 gain on the exchange could not be reported by the installment method.

[35] Treas. Reg. 1.453-5(a). See also Treas. Reg. 1.61-6(a).

[36] Rev. Rul. 55-79, 1955-1 CUM. BULL. 370; Arkay Drug Co., CCH Tax Ct. Mem. 1194, P-H Tax Ct. Mem. ¶ 64,739 (1944).

[37] Rev. Rul. 57-434, 1957-2 CUM. BULL. 300.

ment or personal property used in the business, the other as a term sale of the business real property requiring a cash down payment below the 30 per cent requirement. The cash sale contract would be a closed transaction; the other contract would be an installment sale. In *Andrew A. Monaghan,*[38] the taxpayer sold his business and transferred the inventory by a separate agreement. The inventory sale was not included in a later computation of the 30 per cent limitation.

PAYMENTS IN THE YEAR OF SALE: Payments received in the year of sale cannot exceed 30 per cent of the selling price. The payments test includes both the down payment and any later payments received on the installment obligation in the year of sale. Hence, these *initial* payments include not only cash and other property received (except the buyer's indebtedness given as part of the sale price)[39] under the contract, but also "all other payments received." This latter, broad category of payments includes any of the seller's liens or accrued expenses assumed and *paid* by the buyer in the year of sale.[40]

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38 40 T.C. 680 (1963). A single deed of conveyance was divided into two parts because the parties had agreed to first apply the installment payments to the contract price of the residence rather than the remainder of the property conveyed by the deed. Nathan C. Spivey, 40 T.C. 1051 (1963).

39 The indebtedness not counted for this purpose includes mortgages, notes, or other obligations and any interest received on them in the year of sale. Mamie E. Einig, 19 B.T.A. 1105 (1930); A. Plumer Austin Estate, 10 B.T.A. 1055 (1928); And this applies even though the note might be secured by collateral. A. L. Brown Coal & Coke Co., 14 B.T.A. 609 (1928). However, a pay-off of an existing mortgage by the buyer at the time of sale is counted; also, the prepayment of any installment payment not due until a later year. Blanche Spielberger, 58-1 U.S. Tax Cas. ¶ 9431, 1 Am. Fed. Tax R.2d 1435 (S.D. Calif. 1958).

The other property received can include stocks, bonds, notes, or mortgages from a third party held by the buyer and given as part of the transaction. J. W. Elmore, 15 B.T.A. 1210 (1929); Georgia & Florida Land Co., 16 B.T.A. 1253 (1929); contracts receivable assigned. Tombari v. Commissioner, 299 F.2d 389 (9th Cir. 962); loans by a buyer payable out of the sales proceeds. James Hammond, 1 T.C. 198 (1943); and even an arrangement by the seller allowing the buyer to obtain a new mortgage. Shubin v. Commissioner, 67 F.2d 199 (3rd Cir. 1933), *cert. denied,* 291 U.S. 664 (1934).

40 Rev. Rul. 60-52, 1960-1 CUM. BULL. 186. This also covers payment of the seller's attorney fees. Wagegro Corp., 38 B.T.A. 1225 (1938); the mere exchange

A continuing mortgage lien of the seller is not counted as a payment in the year of sale unless it exceeds the seller's basis. According to the rules, if there is an excess, it is considered a payment in the year of sale in the computation of "the total contract price." This interpretation applies whether the mortgage is specifically assumed or the property is taken subject to the mortgage.[41]

However, if by the terms of the contract, the buyer neither takes the property subject to the existing mortgage, nor specifically assumes it in the year of sale, the amount that the mortgage exceeds the basis may not become part of the total payments received. This can happen if the contract provides for a conveyance sometime in the future while the seller continues his mortgage payments and remains liable for them until the time of actual conveyance.

In *United Pacific Corporation*,[42] a seller sold real property subject to a mortgage in excess of its basis. The seller agreed to continue payments on the mortgage until he recovered his equity from the buyer's payments. When the seller's equity was recovered, the buyer would assume the mortgage balance and continue the payments. The seller remained liable until 1960 (not the year of sale). In 1960, the buyer assumed the remaining mortgage balance and the seller's mortgagee entered the buyer's name on its books as the payor of the loan. The Internal Revenue Service

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of checks between the parties as payment. Corona Flushing Co., Inc., 22 B.T.A. 1344 (1931). However, these items must actually be paid in the seller's tax year of sale; otherwise they are not considered part of the payments in the year of sale. Katherine H. Watson, 20 B.T.A. 270 (1930).

Amounts received from the later assignment or other disposition of the buyer's obligation in the year of sale are not considered payments in the year of sale. This is a separate transaction. Any gain or loss, however, must be computed and included in the seller's tax return for that year. INT. REV. CODE of 1954, § 453(d); Miller Saw Trimmer Co., 32 B.T.A. 931; Duram Building Corp. v. Commissioner, 66 F.2d 253 (2nd Cir. 1933).

41 Treas. Reg. 1.453-4(c); Schneider, Trustee v. Collector, 47 F.2d 1006 (6th Cir. 1931), *cert. denied*, 284 U.S. 622 (1931); Commissioner v. S. & L. Building Corp., 288 U.S. 406 (1933).

42 39 T.C. 721 (1963). See also Stonecrest Corp., 24 T.C. 659 (1955) and E. P. Lamberth's Estate, 31 T.C. 302 (1958) on this problem.

took the position that the amount of the mortgage exceeding the basis of the property was part of the payments received by the seller in the year of sale, whether or not the buyer, by the terms of the sale contract, technically took the property subject to, or assumed the obligation to pay, the mortgage.

The court, however, considered the contract of sale as controlling. It held that there had been neither a present *assumption* of the mortgage nor a taking of the property *subject* to the mortgage, as those expressions are customarily used.

SECURITY AND ESCROW ARRANGEMENTS: Earnest money deposits or option payments received as part of the sale price in the year of sale become part of the initial payments.[43] However, cash or property held in escrow to be applied to the purchase price might be given different treatment. The status of escrowed cash or property depends on its actual application under the escrow terms. Thus, escrowed cash or property can become part of the payments in the year of sale. One method of fixing the status of the cash or property placed in escrow is to use security arrangements.

In *Gibbs & Hudson, Inc.,*[44] third party notes owned by the buyer did not become initial payments when they were escrowed until the buyer paid his own note, although property of this type is ordinarily counted when assigned and turned over outright as part of the transaction.

DEBT CANCELLATION AND BUSINESS LIABILITIES: Closely allied to payment of the seller's liabilities in the year of sale is the problem raised by a cancellation of seller's debt to the buyer. If the seller's debt to the buyer is absorbed as part of the purchase price, it is counted as a payment in the year of sale. Additionally, there is an important dis-

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[43] Waukesha Malleable Iron Co. v. Commissioner, 67 F.2d 368 (7th Cir. 1933); Newaygo Portland Cement Co. v. Commissioner, 77 F.2d 536 (D.C. Cir. 1935).

[44] 35 B.T.A. 205 (1937). The same result occurs when part of the sale proceeds is escrowed as security for a seller's covenant not to compete. Rebecca J. Murray, 28 B.T.A. 624 (1933).

tinction to be drawn between the buyer's cancelling the seller's debt to buyer, and the buyer's payment of a seller's liabilities to outsiders.

In one case[45] taxpayers owning 50 per cent of a corporation's stock sold it back to the corporation in 1957. The selling price included a cash down payment, a cancellation of a debt then owed to the corporation-buyer, and an installment note from the corporation to the seller. The corporation gave a release and cancelled the taxpayer's debt on its 1957 books. Since the taxpayer's debt to the corporation was cancelled in 1957, this amount was included in the payments for the year of sale, bringing the payments for the stock in the year of sale over the 30 per cent limit.

On the other hand, the case of *Marshall v. United States*[46] presented a situation in which a taxpayer sold his proprietorship assets to a corporation he had formed for this purpose. As part of the sale price, the corporation agreed to assume the business accounts payable, a debt the sole proprietorship owed to the seller-taxpayer, and gave an installment note for the balance due on the sale price. During the year of sale, the corporation paid both the sole proprietorship debt to the taxpayer and the assumed business accounts payable. Using the installment method, the taxpayer considered only the liability to him and payments received on the installment note during the sale year in applying the 30 per cent test. He did not consider the assumed business accounts payable, which he in fact collected as payments received in the year of sale. The court agreed with the taxpayer, equating assumed business accounts payable with real estate mortgages assumed by a buyer. In effect, this meant that the general liabilities of the business (as contrasted with debts owed to the buyer) assumed and paid

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45 Robert B. Riss, 23 CCH Tax Ct. Mem. 1899, P-H Tax Ct. Mem. ¶ 64,308 (1964).

46 241 F. Supp. 30 (S.D. Calif. 1964). While this case seems to indicate a distinction between the buyer's cancelling the seller's debt to the buyer and paying the seller's liabilities to others, its standing is questionable when compared with other authority. Rev. Rul. 60-52, 1960-1 CUM. BULL. 186 specifically holds that the liabilities of a seller assumed and paid in the year of sale are payments received in the year of sale.

during the year of sale were not included in applying the 30 per cent test.[47]

Stephan A. Cisler, Jr.[48] should not be ignored in this context. In *Cisler,* the court treated the buyer's assumption of the seller's debt against the stock (it had been pledged as collateral security for a loan) as a payment in the year of sale. Since the seller had no basis for this stock, the general rule in real property sales for inclusion of mortgage amounts in excess of basis was carried over to casual sales of personal property. The court considered a claim against personal property in the form of a security arrangement to be similar to a mortgage under these circumstances.

A recent case[49] indicates a slightly different twist on the cancellation or assumption of debt problem. The seller decided to break off his association with a corporation and sold all his shares to the corporation in 1959. The terms provided for nine annual installment payments, to commence in 1960. Seller owed the corporation some money, so the parties decided to pay off this debt by having the corporation withhold certain amounts from the installments due in the last four years of the nine-year period. The court held that no payments on the seller's debt were received in 1959, the year of sale. Clearly, then, a taxpayer can effectively de-

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47 Another case has reached the same result in a situation closely resembling a business indebtedness. In Denco Lumber Co., 39 T.C. 8 (1962), a builder placed first mortgage loans on homes he built. At the time of sale, the buyer would assume the first mortgage placed by the seller and give a second mortgage for the balance of the sale price. The builder did not have to include the amount of the first mortgage assumed by the buyer as payments received in the year of sale.

Contrast this with a situation in which the mortgage liability has accrued at the time of sale and the buyer assumes and pays it. Sterling v. Collector, 3 F. Supp. 386. (S.D. Me. 1933).

48 39 T.C. 458 (1962). The seller had no basis for the stock, however, so the debt appears to be included in the year of sale because the amount of the debt assumed exceeded the seller's basis. The court noticed this in Marshall v. United States, 241 F. Supp. 30 (S.D. Calif. 1964) and concluded that without this excess-basis problem, the court in the *Cisler* case would not have treated the seller's debt for the stock sold as a payment in the year of sale.

49 *In re* Lipman's Estate v. United States, 245 F. Supp. 393 (E.D. Tenn. 1965).

lay the cancellation of a seller's debt by agreement until a time beyond the year of sale.

THE EFFECT OF STATE LAW ON YEAR OF SALE: The installment method may be used either when there is an immediate transfer of title, or when the title transfer is postponed until all or part of the selling price is paid.[50] Problems can arise, nonetheless, in fixing the proper year of sale or *other disposition* when applying the 30 per cent limitation to the payments received. Ordinarily, this is the year the sale is closed or the year in which the contract rights become fixed. Although an executory contract may have been signed[51] in a prior year, the taxpayer cannot defer the tax consequences by using an option or by having the sale price paid into escrow and distributed in installments.[52]

State law will play an important part when determining the nature of the sale contract for this purpose. In *Robert J. Stuart,*[53] a sale agreement for real property was signed in 1954, postponing the passing of title and the taking of possession until 1955. Less than 30 per cent of the selling price was received in 1954, and more than 30 per cent was received in 1955. The contract also provided that if the buyer defaulted he would forfeit all payments as liquidated damages and be released from all liability including an action for specific performance. The court held that the provision for liquidated damages and release of any further liability on default transformed the agreement into an option under state law. The option, as distinguished from an agreement of sale, imposed no binding obligation on the buyer until 1955 when he delivered another cash pay-

[50] Treas. Reg. 1.453-4(a).

[51] Warren Nat'l Bank v. Commissioner, 61 F.2d 325 (3d Cir. 1932). If a broker receives the first payment but does not deliver it to the seller until the following year, the year of receipt by the seller is the year of sale. M. L. Elken, 7 B.T.A. 1160 (1927). If the sale is contingent on approval from outside parties, the year of approval becomes the year of sale. Daniel Rosenthal, 32 T.C. 225 (1959). It can also be postponed where there is a continuing offer which the buyer can refuse by forfeiting a percentage of the price agreed upon. Parish-Watson & Co. Inc., 4 B.T.A. 605 (1926).

[52] Williams v. United States, 219 F.2d 523 (5th Cir. 1955).

[53] Commissioner v. Stuart, 300 F.2d 872 (3rd Cir. 1962). See also Parish-Watson & Co. Inc., 4 B.T.A. 605 (1926).

ment, a purchase money mortgage, and received the deed. Therefore, the 30 per cent rule was not met.

Although mere retention of title as legal security in the agreement does *not* postpone the 30 per cent year, the inclusion of provisions for damages based on previous payments or on a certain percentage of the agreed sale price may have that effect. Postponement of the 30 per cent year may also result if the original sale agreement becomes void under state law.

For example, in *Robert L. Cummer*[54] the taxpayers sold land to a city under an escrow-type agreement which divided the entire property sold into three different parcels. Title to each parcel was to pass in three different tax years. A part of the total purchase price was to be paid each year. The sale was void under the state constitution because the voters did not have an opportunity to vote on a municipal debt of this size. As a consequence, the court treated the whole transaction as three independent sales in three different tax years.

The above rules must be considered to qualify sale transactions for installment sale treatment. They also provide opportunities for tax planning if the parties use sale terms to control the conditions of the closing and the passing of title, or to vary the nature of the sale agreement.

GROSS PROFIT REALIZED: Assuming that the installment method is otherwise available for reporting the transaction, the gross profit realized is the next aspect of the sale to be examined. Gross profit is usually the selling price less the adjusted basis.[55]

Selling expenses also affect the gross profit if the seller is a non-dealer. These expenses include commissions, advertising, and other miscellaneous transfer costs paid as a part of the transaction. However, this is the only time

[54] Robert L. Cummer, 62-1 U.S. Tax Cas. ¶ 9344, 9 Am. Fed. Tax R.2d 1091 (S.D. Calif. 1962).

[55] Treas. Reg. 1.453-1(b); INT. REV. CODE of 1954, § 1011.

during the computations of installment reporting when they are considered.[56]

A non-dealer subtracts these expenses from the selling price to determine the gross profit realized for both casual sales of personal property and for sales of real property. In effect, this allows a reduction of expenses pro rata over the period that the payments are collected.[57]

For example, a non-dealer taxpayer sells real estate held without any encumbrances for a $20,000 selling price. The adjusted basis of the property is $10,000 plus $2,000 for selling expenses actually paid. The $2,000 of selling expenses are only charged against the $20,000 selling price to determine the gross profit realized. In this example, the gross profit would be $8,000.

TOTAL CONTRACT PRICE: The next step in computing the reportable gain resulting from the installment payments received each taxable year is to determine the total contract price. Ordinarily this would be the total amount *actually paid* to the seller in cash, notes, *and other property for the transfer.* Unlike the computation of selling price, the general rule for determining total contract price *excludes* any existing mortgage, whether or not the buyer assumes or takes the property subject to the mortgage.[58] An exception to the general rule applies if the amount of the mortgage exceeds the seller's basis. In these latter situations, the excess amount is included in the total contract price computation.[59]

For example, a taxpayer sells real property having a basis of $10,000 for a price of $40,000, but subject to a $20,-

[56] Treas. Regs. 1.453-1(b); 1.453-4(c).

[57] They are not deductible in full in the year of sale. Elvie N. Hazlett, 23 B.T.A. 303 (1931).

[58] Pacheco Creek Orchard Co., 12 B.T.A. 1358 (1928). If there is no mortgage on the property, the contract price is the selling price and the gross profit is computed by using the selling price.

[59] Treas. Reg. 1.453-4(c); Schneider, Trustee v. Collector, 47 F.2d 1006 (6th Cir. 1931), *cert. denied,* 284 U.S. 622 (1931); Commissioner v. S. & L. Building Corp., 288 U.S. 406 (1933). Any other liens or obligations of the seller are also included if the buyer has to pay them.

000 mortgage. The total contract price is $50,000 (the $40,000 selling price plus $10,000 of the mortgage exceeding the taxpayer's basis). However, if the basis of the property were $30,000, the total contract price would remain at $40,000 because the $20,000 mortgage would *not* be in excess of the basis.[60]

The peculiar facts in each case or the wording of the sale contract can also alter the general rule, resulting in an inclusion of the *full* amount of the mortgage in the computation of total contract price.

If it is impossible in the year of sale to determine whether or not the buyer has taken the property subject to the mortgage or if he will ever assume it, the full amount of the mortgage is included in computing the total contract price.[61] The same exception to the general rule applies, if as part of the purchase price, other property is placed in escrow.[62] For example, in *United Pacific Corporation,*[63] the seller agreed to apply his payments received from the sale toward payment of his existing mortgage for a certain number of years and thereafter to convey the property to the buyer who would then assume the payments. The court noted that the property was not taken subject to the mortgage or assumed by the buyer as one of the terms of the sale contract. For these reasons, the court, in fixing total contract price, included the full amount of the mortgage rather than the amount that the mortgage exceeded the seller's adjusted basis.

GAIN PERCENTAGE: If a particular sale transaction falls within the installment reporting rules, the taxpayer must report the percentage of gain received in the annual installment payments on his federal income tax return. The ratio between the *gross profit realized* and the *total contract*

60 The selling price in both situations would be $60,000. This includes the sale price of $40,000 plus the mortgage of $20,000 whether or not it was specifically assumed by the buyer as a part of the transaction.

61 G.C.M. 3048, VII-1 CUM. BULL. 60 (1928).

62 See Gibbs & Hudson, Inc., 35 B.T.A. 205 (1937).

63 39 T.C. 721 (1963). See also Stonecrest Corp., 24 T.C. 659 (1955) and E. P. Lamberth's Estate, 31 T.C. 302 (1958) on this problem.

price indicates the gain percentage. Consider a hypothetical situation of an installment sale.

On December 1, 1966, Taxpayer sells 160 acres of grazing land[64] to Buyer. The land has a $20,000 basis in Taxpayer's hands, is subject to a $25,000 mortgage, and his selling expenses are $2,000. The sale agreement provides: Buyer takes the property subject to the $25,000 mortgage, pays accrued property taxes of $1,000 and interest of $1,000 which Taxpayer owes on his mortgage,[65] and makes a $3,000 down payment. In addition, Buyer agrees to pay an additional $20,000 to Taxpayer at the rate of $5,000 a year in 1967, 1968, 1969, and 1970. All of these events take place in 1966. In electing the installment sale provisions, Taxpayer should go through the following computations:

I. Selling Price.

1966 Cash Payments	$ 3,000
Future Payments Due	20,000
Mortgage Interest Paid	1,000
Property Taxes Paid	1,000
Mortgage on Property	25,000
TOTAL	$50,000

II. Payments in the Year of Sale.

Cash Payment in 1966	$ 3,000
Interest and Taxes Paid by Buyer	2,000
Mortgage Excess Over Basis	5,000
TOTAL	$10,000

64 Since only land is sold, there is no problem of depreciation recapture under INT. REV. CODE of 1954, § 1250.

65 Because buyer pays the seller's obligation for interest and the back property taxes (a lien on the property) in 1966, the amounts are considered payments received in the year of sale. See INT. REV. CODE of 1954, § 164, dealing with the deduction of taxes in a taxable year. Treas. Reg. 1.164-6 provides special rules in prorating the property taxes for the year of sale. These rules allow a deduction to a cash-basis seller for the taxes assumed by the buyer.

III. Election Ratio.

$$\frac{\text{1966 Payments (from II above) \$10,000}}{\text{Selling Price (from I above) ....\$50,000}} = 20\%$$

IV. Gross Profit Realized.

Selling Price (from I above)		$50,000
Less:		
Basis	$20,000	
Selling Expenses	2,000	22,000
GAIN		$28,000

V. Total Contract Price.

Cash and Agreement	$23,000
Interest and Taxes Paid	2,000
Mortgage Excess	5,000
TOTAL	$30,000

VI. Gain Percentage.

$$\frac{\text{Gross Profit ....\$28,000}}{\text{Contract Price ....\$30,000}} = 93\ 1/3\%$$

VII. Gain Reportable in 1966.

Gain Percentage (93 1/3%) ×
1966 Payments ($10,000) = $9,333.30

Taxpayer should enter the applicable figure from the preceding computation on Schedule D of his 1966 income tax return. If the transaction is a capital gain, Part I of the schedule should be used. If not, the entry should be made in Part III. The entire computation does not have to be repeated in later years. The following entry on subsequent schedule D's should be sufficient:

Gain from 1966 Installment Sale.

$$\frac{\text{Contract Price \$30,000}}{\text{Gross Profit ....\$28,000}} = \text{93 1/3\% (Gain Percentage)} \times \text{\$5,000 (1967 [-70] payments)} = \$4,666.65$$

CONCLUSION

It is obvious that the use of the installment sale provisions for reporting gain can be beneficial to taxpayers. Although these provisions merely divide the gain among the years of collection, they have the effect of postponing any tax due until there is money available for payment. It is equally obvious that application of these provisions to a particular transaction may result in a number of "tax-traps" for the unwary. The provisions are exacting; the terminology is restrictive. Ordinary terms acquire a special meaning.

One additional warning is appropriate. Assuming that the provisions have been carefully followed step-by-step and that the transaction qualifies, later events can change the entire tax picture. The provisions[66] also specify that a later disposition of an installment obligation produces taxable income in most instances. The amount of income depends upon the nature of the subsequent transfer. Thus, any subsequent dealing with an installment obligation requires a re-examination of the possible tax consequences.

In the usual case, however, a potential sale transaction can be tailor-made to fit within (or outside) the installment reporting provisions, depending on the result desired. A general knowledge and judicious use of the provisions will provide an excellent opportunity for tax planning.

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[66] INT. REV. CODE of 1954, § 453(d) requires the reporting of gain or loss when an installment obligation is satisfied at other than its face value, distributed, transmitted, sold, or "otherwise disposed of." The gain or loss is the difference between the basis of the obligation and the amount realized, or the fair market value of the obligation, depending on whether there is satisfaction, sale or exchange, or some other form of disposition. However, certain tax-free exchanges, corporate liquidations, transfers at death, and repossessions, have special rules. The gain or loss (if recognized) takes place in the year the transfer occurs and is considered to result from the sale or exchange of the property represented by the installment obligation. Furthermore, all these rules only apply to transactions if section 453 was elected; they do not apply to other deferred payment sales.