Bloomberg Tax

Tax Management
Real Estate Journal™

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The Installment Method: Misuses That Make Me Lose Sleep

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The nice thing about owning property is that you pay no tax until you sell. The downside is that the longer you own, the more selling hurts. Thankfully, there are ways to rollover your equity into a new investment, tax free. One is to use the old investment as security for a loan. Another is a §1031[1] or other nonrecognition transaction. This article discusses a third method, the seller-financed ''installment sale'' under §453.

To me, the installment method feels like a legal loophole. It lets you earn income on money which otherwise would have belonged to the government. Installment sales work like §1031 exchanges: The interest payments are taxed like rent from the replacement real property. Principal payments are taxed like partial dispositions of that property. They are more flexible than §1031 transactions, in that the relinquished asset need not be real property. Even better, the buyer gets a cost basis, before he has paid anything. Ideally, the income from the note is more reliable than the income from the seller's old business. If the buyer's creditworthiness is in doubt, the parties can pay an assignment company to guarantee the note.[2]

The installment method is rightly the first suggestion on every tax planner's tongue. However, it is not always an option. This article summarizes those situations. I group them into three categories: (i) express prohibitions related to the nature of the asset sold; (ii) express prohibitions not related to the nature of the asset sold; and (iii) substance-over-form issues.

EXPRESS PROHIBITIONS RELATED TO NATURE OF ASSET SOLD

Sometimes, installment treatment is denied because of some feature of the property sold. In the table below, the left column identifies the ineligible assets. The right column describes how to treat the sale of an interest in a partnership which owns these assets (i.e., whether we ''look through'' the partnership and test its underlying assets).

Assets Not Eligible for Installment Method	Do We Look Through a Partnership?
Inventory.[3]	Probably yes. See Rev. Rul. 89-108, which denies installment treatment to ''substantially appreciated'' inventory in §751(a). Subsequently, §751(a) was amended to include all inventory.
Depreciable property, to the extent of depreciation recapture.[4] This is generally limited to personal property.[5]	Yes.[6]

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This article may be cited as Andrew Gradman, *The Installment Method: Misuses That Make Me Lose Sleep*, 38 Tax Mgmt. Real Est. J. No. 5 (May 18, 2022).

[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] See Robert W. Wood, *Structured Sales: Breathing Life Into Installment Sales*, Tax Notes (July 11, 2005).

[3] §453(b)(2)(B).

[4] §453(i).

[5] §1245. *Compare* §751(c)(2) (other forms of recapture) and §1(h)(6) (''unrecaptured §1250 gain'' for real property).

[6] *See* §453(i).

Depreciable property, if buyer and seller are related.[7]	In an old PLR the IRS declined to apply look through treatment to a partnership.[8]
Debt-encumbered property, to extent the resulting relief of debt exceeds the basis of the property.[9]	Yes. Debt relief is not affected by holding the debt through a partnership.
Other installment obligations.[10]	Probably yes.[11]
Personal property under a revolving credit plan.[12]	Yes, in light of the discussion for inventory and installment obligations above.
Publicly traded stock.[13]	No direct authority. Some commenters argue that, by specifically providing for look through in certain cases, Congress rejected it for all other cases.[14]

Congress has give instruction to the Treasury to prescribe regulations providing that, in installment sales, the sale of a partnership interest ''will be treated as a sale of the proportionate share of the assets of the partnership.''[15] Treasury has not yet done so, and it's unclear what force the statute has in their absence.[16]

EXPRESS PROHIBITIONS NOT RELATED TO NATURE OF ASSET SOLD

In other cases, installment treatment is disallowed for reasons not closely connected with the nature of the asset sold. These include:

- Sales by dealers;[17]
- Installment obligations secured by cash or cash equivalents;[18]
- Installment obligations offered as security for another loan;[19]
- Installment obligations which are payable on demand or readily tradeable;[20]
- Sales in a particular year, if the seller holds installment obligations arising during that year of more than $5 million. Installment treatment is not denied, but the taxpayer owes interest on the excess;[21]
- Sales to a related party, who resells the asset without having borne the risk of loss in value for at least two years; and[22]
- Election out.[23]

SUBSTANCE (EQUITY) OVER FORM (DEBT)

The third constraint is that the seller must shift from an equity to a debt position. This is implied, if not stated, in the Code and Treasury regulations.[24] Continuing the §1031 analogy, her ''replacement'' property can only be the buyer's note; her new activ-

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[7] §453(g).

[8] *See* PLR 8052086.

[9] Temp. Reg. §15a.453-1(b)(3)(i).

[10] §453B; Rev. Rul. 60–352.

[11] *See Mingo v. Commissioner,* 773 F.3d 629 (5th Cir. 2014) (looking through to unrealized receivables).

[12] §453(k)(1).

[13] §453(k)(2).

[14] *See* Manning and Wilson, 718-3d T.M., *Partnerships – Disposition of Partnership Interests or Partnership Business; Partnership Termination*

[15] §453A(e).

[16] *See* Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations* (analyzing when delegations to create regulations have independent legal force); Field Service Advice, 1995 FSA Lexis 124 (Sept. 11, 1995) (citing §453A(e)(2) and Rev. Rul. 89-108 as authority to treat sale of partnership interest as sale of proportionate shares of partnership assets).

[17] §453(b)(2)(A), §453(l).

[18] Temp. Reg. §15a.453-1(b)(3)(i); *see* Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶108.3 (''cash equivalent'' likely does not include widely traded stocks; however, ''prudence counsels against securing an installment obligation with a pledge of any debt instrument for which a market exists.'').

[19] §453A(d).

[20] §453(f)(4).

[21] §453A(c).

[22] §453(e).

[23] §453(d).

[24] *See* §453(c) (assuming an ascertainable ''contract price''); Temp. Reg. §15a.453-1(c)(1) (allowing a contingent value right, but not a ''retained interest . . . in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions''); §453(b)(1) (assuming a ''disposition,'' again incompatible with a retained interest); §453(e) (regulating related-party installment sales, where sellers can effectively internalize the value of the new business in the intermediary's hands — an indirect form of equity); §453A(d) (forbidding pledging, which would allow a lower interest rate on a loan — effectively the same as a higher, more equity-like rate of interest on the installment note); §453(f)(4) and Temp. Reg. §15a.453-1 (prohibiting demand notes and constructive receipt; this prevents seller from calling the note if she finds a better use for the money, or from dictating to intermediary a timeframe for liquidating seller's old asset). *Cf.* Temp. Reg. §1.1002-1(b) (nonrecognition rules ''are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception;'' the exchange must satisfy ''the underlying purpose for which such exchange is excepted from the general rule.''). I find the analogy between the installment method and nonrecognition to be compelling. *Cf.* Bittker, McMahon & Zelenak, *Federal Income Taxation of Individuals*, Chapter 39 (it is ''far from clear'' whether the specialized provisions which we refer to as accounting methods constitute ''mini-methods of accounting or should be viewed instead as rules of substantive tax law.'').

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ISSN 8755-0628

ity must consist solely of earning interest on a principal amount equal to the pre-tax sales price of her old business.

But what if she is not interested in becoming a lender? Using §453, is it possible to exchange into a non-lending (equity-like) position? In my view, this is what the promoters of intermediary installment sales[25] seek to offer. As I use the term, these are marketed transactions which commence when a seller decides to sell an asset (OldCo) to a third-party buyer for a price. The promoter introduces seller to intermediary. Intermediary purports to buy OldCo from seller for an installment note in the principal amount equal to the nominal sales price. Immediately after, intermediary sells the asset to buyer for the same price in cash (tax free, because amount realized equals basis). Intermediary uses the cash to buy some new asset (NewCo), whose earnings are used to service the note payments to seller.[26]

These transactions are popular. However, I fear that in aggressive cases, the IRS could decide that the ''debt'' crosses the line into a retained interest — that is, synthetic equity in NewCo. The most aggressive arrangements flirt with this line by including three features:

(i) First, seller can influence how intermediary reinvests the cash proceeds. This may be as simple as identifying her risk tolerance, or could get more specific (e.g. choosing between Treasury bonds, S&P 500 stocks, or cryptocurrency).

(ii) Second, intermediary's ''note'' has an above-market interest rate. To the extent of this excess, this shifts the value of intermediary's equity in NewCo to seller.

(iii) The above-market interest also increases the likelihood that intermediary will default on the loan. Nevertheless, as a third feature, the loan will be inadequately secured. That is, it will be secured only by NewCo itself; it will not be personally guaranteed by intermediary or its principals.

At the extreme, these are not installment sales. They are service relationships, where seller pays for the service of (1) acting as seller's sales agent in the sale to buyer, and (2) signing documents which conceal this fact.[27] If the IRS made this determination, intermediary's ''sale'' to buyer would trigger immediate gain to seller.

Some planners argue that the IRS will be assuaged because intermediary has an independent profit motive.[28] However, I believe this asks the wrong question. It defends intermediary's investment activities, when the difficulty is how to defend seller's decision to sell to intermediary rather than buyer in the first place. I cannot see a non-tax purpose for this, at least for intermediary installment sales as I have defined them.

Even if there is a business purpose, the problem remains that the transaction's substance differs from its form. The latter doctrine is illustrated in *Estate of Franklin v. Comissioner*,[29] *Franklin* involved an owner of real property who tried to (formally) ''sell'' the property to a group of doctors, but solely for tax purposes (i.e., to give them the depreciation deductions), without losing the true benefits of ownership. He accomplished this by selling the property for a note, secured only by the property, then leasing it back from the doctors. Significantly, the note was a balloon note (no principal due until maturity), and the balloon payment far exceeded the expected value of the property. This made it highly unlikely that the doctors would ever pay down the note. Instead, they would choose to default, leaving everyone in the position as if the ''sale and leaseback'' had never taken place, but for the shifting of depreciation from owner to doctors, in exchange for the payment from doctors to owners of ''interest'' on the note (which functioned as the fee for this service).

The Ninth Circuit rejected the notion that the doctors had really bought the property (and thus, the notion that they had acquired the ''seller's'' right to the depreciation deductions). It explained:[30]

> An acquisition. . . . [financed entirely with nonrecourse purchase money debt]. . .if at a price ap-

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[25] I adopt this term from Alan S. Lederman and Matthew E. Rappaport, *Intermediary Installment Sale Transactions*, 32 Tax Mgmt. Real Est. J. No. 10 (Oct. 5, 2016). A recent article instead uses the term ''Structured Installment Sale.'' Michael Burwick and Kyle Kadish, *The Structured Installment Sale as a Real Estate Tax Strategy*, 37 Tax Mgmt. Real Est. J. No. 11 (Nov. 17, 2021). I avoid that term, because Robert Wood applied it long ago to a simple guarantee by an assignment company, see Note 2, above.

[26] This is an intentional caricature. A competent planner would introduce some variations to prevent recharacterization under *Court Holding* principles. I intend my definition to include these variations, as long as the substance is not meaningfully affected.

[27] *Cf. Knetsch v. United States*, 364 U.S. 361 (1960) (the $91,570 difference retained by the company was its fee for providing the facade of ''loans'' whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68).

[28] *See, e.g.,* Michael Burwick and Kyle Kadish, Note 25, above (the intermediary has the ''the bona fide intention of earning a return above and beyond the interest that is promised by legal agreement . . . to the seller and the expenses related thereto''); Michael Burwick and Kyle Kadish, *Capital Gains Tax Mitigation and the Structured Installment Sale*, Daily Tax Rep. (Nov. 4, 2021) (the intermediary will ''make investments that attempt to exceed its obligation pursuant to the promissory note, thereby satisfying the Business Purpose Rule.'').

[29] 544 F.2d 1045 (9th Cir. 1977).

[30] *Id.* at 1048.

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ISSN 8755-0628

> proximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.
>
> No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase.

Franklin's holding can be summarized in the following way. The greater the disparity between the fair market value (FMV) of the sold asset and the FMV of the promised future payments, the greater the odds that the buyer will default, and the greater the odds that the sale was a sham. Applying this to intermediary installment sales, substance will differ from form to the extent that the appraised value of the intermediary's "note" (valued as if it were adequately guaranteed) exceeds the value of seller's OldCo. The more this is so, the more likely it is that Seller entered into the transaction with an understanding that intermediary might exhaust his assets, become insolvent, and default. The natural explanation is that seller accepted this sacrifice in exchange for the greater upside of an equity-like position.

This does not mean the IRS will have an easy time winning these cases. In *Franklin*, the disparity in value was stark. This may be harder for the IRS to show in intermediary installment sales, where the main piece of evidence — the interest rate — can vary widely even in bona fide transactions. Many (perhaps most) intermediary installment sales will survive audit.

But this also does not mean the transaction "works." It simply means that taxpayers are at the mercy of the IRS's priorities. Last year, in CCA 202118016, the IRS announced it was studying a particular form of intermediary installment sale, the "monetized installment sale." It cited *Franklin*. What it will do next is anybody's guess.

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ISSN 8755-0628