Selling Real Estate: Improving Installment Sales

by Robert W. Wood, Esq.*

These days, real estate investors may be more taken with TIC's and other exotica than with plain old installment sales. That is too bad, for installment sales offer often-overlooked advantages. Ever since the Installment Sales Revision Act of 1980[1] liberalized the area dramatically, for more than 25 years now, there has been a vastly more liberal installment sale regime.

Among other changes, the Installment Sales Revision Act of 1980 made clear that a standby letter of credit can be issued in the name of the installment seller to provide security. The installment seller can always take back a security interest in the property sold, but that often represents inadequate security. A security interest in real estate can be comforting if you're in first position, but sometimes that spot is taken. Besides, foreclosing on the sold property is cumbersome and inconvenient, even if the seller is able to turn around and sell it again.

Today, a typical installment sale entails a promissory note and security. Plus, the note may be backed by a standby letter of credit. If there is a default on the note, the taxpayer/seller can go to the bank and present the letter of credit for payment. That is fast and easy, far more efficient than realizing on traditional security — whether in the form of real estate or otherwise.

For example, the seller who sells investment real estate in return for a 20-year stream of payments may request a standby letter of credit (as well as a security interest in the real estate). If there is a default on the installment note in year three, the seller can go to the bank and request payment (assuming the letter of credit is still in effect).

In all likelihood, though, the letter of credit will pay the *full* amount on any default, not just the then-due installment. One default typically accelerates all extant payments. The installment seller wants to get paid, but what he *really* bargained for was the *stream* of payments over 20 years. Even if the seller can draw down only the then-due installment under the terms of the letter of credit, there is the problem of the continuing mechanics of the standby letter of credit. If there is a default in year three, will the letter of credit still be outstanding?

As most banks will issue a letter of credit for only 12 months at a time, there are generally cumbersome renewal provisions in the note, purchase and/or security documents. A seller can be left with the Hobson's choice whether to let a letter of credit lapse or to draw down on it, thus destroying the installment treatment for which he bargained. In a quest for alternate security, the installment seller may look for security in the assets sold.

Clearly, a deed of trust on real estate can provide solace to the seller. Yet the seller is really banking against the possibility that there will be a default under the note. If there is, then the deed of trust will nearly always compel the installment seller to foreclose and to realize as much cash as possible, destroying the installment treatment. When the seller is faced with the specter of not being paid, the initially desirable stream of payments and corollary tax deferral will pale compared to the prospect of not being paid at all. Nevertheless, this is a choice the seller may not want to make.

Installment Sale Structure

Some sellers of investment real estate are discovering a way to have security as well as installment treatment without serious risk of acceleration. The structured sale involves an installment transaction in which the buyer arranges to buy investment real estate from the seller. The installment sale agreement obligates the buyer to make specified periodic payments for a stated number of years. The buyer may (or may not) make a down payment in the year of sale. The buyer's obligation and note is personal to the buyer. It may (or may not) be secured by the purchased assets.

This is merely an installment sale under §453,[2] entitling the seller to report the payments as he receives them. In the structured sale, however, after the sale occurs, the buyer assigns its obligations under the installment sale agreement to an assignment company. The buyer transfers a lump sum to the assignment

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[1] See Installment Sales Revision Act of 1980, P.L. 96-471, 94 Stat. 2247.

[2] Unless otherwise indicated, all section references herein are to the Internal Revenue Code, as amended, and the regulations issued thereunder.

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company, representing the discounted value of the stream of payments the buyer is obligated to make under the installment sale agreement.

In return, the assignment company agrees to assume the buyer's payment obligations. Note that this transaction is between the buyer and the assignment company, a third party, which was not a party to the installment sale. Similarly, the installment seller is not a party to the arrangement between the buyer and the assignment company. The buyer and the assignment company negotiate the amount of the lump sum payment based on prevailing discount rates and other factors.

The life insurance company will issue an annuity contract to the assignment company. Thereafter, the assignment company will make all periodic payments called for under the original installment agreement. All terms of the installment agreement continue to apply, including any pledge of collateral or any other arrangements contained in the original installment agreement. Notably, the assignment may not release the buyer from any of its obligations under the installment agreement, although the seller will look to the assignment company as the primary source of payments. If the assignment company fails to perform, the life insurance company agrees to send directly to the seller those periodic payments that come due after the life insurance company receives notice that the assignment company defaulted.

Given that there is nothing about this kind of transaction in §453, or the accompanying regulations, does this transaction work from a tax standpoint? The author believes it does, and in fact that there is little reason the IRS should want to attack it. The balance of this article outlines the various tax doctrines that seem pertinent, and provides some analysis of why they should not be problematic. These include the statutory concept of dispositions of installment obligations, the constructive receipt doctrine, and the economic benefit doctrine.

Fundamentals of Installment Sales

The buyer's periodic payment obligations to the seller constitute indebtedness of the buyer, which is not payable on demand or readily tradable.[3] The periodic payment obligation is not part of the payment received by the seller in the year of sale.[4] Consequently, an assignment of that obligation by the *obligor*, which does not alter the original obligation, should not accelerate income (nor should it result in a disposition of the installment obligation) to the seller. The seller is not a party to that assignment, and the third party does not become directly liable to the seller. If the third party should fail to make the periodic payments, the buyer still will remain liable.

Thus, the periodic payment obligation received by the seller remains indebtedness of the buyer. Of course, the buyer will assign its periodic payment liability to a third party, and this third party will be a primary obligor (and will purchase an annuity to fund this liability). However, the seller will have no rights in the annuity. Traditional timing of income concepts[5] suggest that the seller's lack of interest in the annuity should remove any constructive receipt or economic benefit concerns (topics considered below).

Nevertheless, it is conceivable that the IRS could argue that the periodic payment obligation received by the seller should be viewed as an obligation of the third party. The IRS might argue that the value of the periodic payment obligation should be included in the amount of the "payment" the seller received in the year of the sale, since the third party is not the purchaser of the property. To take this position, the author believes the IRS would, in essence, be arguing that the buyer purchased the property in exchange for the debt obligation issued by the third party.

Although there is no authority directly on point, such arguments would seem to require an integration of the transactions, which is not supported by the facts. Indeed, in *Caldwell v. U.S.*,[6] the buyer formed a holding company to assume the buyer's obligations under the contract. The court held that the buyer, not the holding company, remained the purchaser, and that the seller was receiving the holding company's obligation, not the buyer's. In a structured sale, the installment seller is not a party to the assignment, and the buyer remains contingently liable to the seller, since the seller is not released from liability.

No Disposition?

Section 453B(a) states that if an installment obligation is disposed of, any gain or loss will be recognized immediately. In such a case, the benefits of the installment method are lost. Where an installment obligation is disposed of at other than its face value, any gain or loss is measured by the difference between the basis of the obligation and the amount realized. In all other dispositions, gain or loss is measured on the differ-

[3] §453; *see* Regs. §15A.453-1(b)(3)(i).

[4] *See* §453(f)(3); *Caldwell v. U.S.*, 114 F.2d 995 (3d Cir. 1940).

[5] See Wood, *Taxation of Damage Awards and Settlement Payments*, Ch. 7 (3d ed. 2005).

[6] 114 F.2d 995 (3d Cir. 1940).

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ence between the basis of the obligation and its fair market value.[7]

A disposition includes not only actual transfers of installment obligations to other parties, but also "deemed dispositions." A deemed disposition occurs when the terms of the installment sale agreement are substantially altered. In effect, the installment obligation is considered to have been exchanged for a new obligation.

In Rev. Rul. 75-457,[8] the IRS concluded that a disposition occurs when the seller's rights are materially disposed of or altered. A large body of law addresses modifications to installment obligations, the key question being whether a modification is significant enough to give rise to a disposition.[9] Generally, these authorities involve a *seller* that transfers its installment note, and the question is whether such a transfer should be considered a disposition. Less attention has been paid to the *buyer* in the installment sale, which may transfer its obligations to pay under the note to a third party. Existing authorities do not specifically address whether a *buyer* can assign its obligations to a third party under an agreement where the third party will make the same periodic payments as the buyer, allowing the seller to continue with installment reporting.

Yet it is hard to see how this could be abused. The seller is not disposing of anything, or even altering it. It seems difficult to argue that this is a disposition when the seller does not take any action. The buyer undertakes a transaction with an assignment company, paying a discounted amount rather than remaining primarily on the hook for the entire stream of installment payments.

The Code and regulations provide only limited guidance whether an assignment of an installment obligation constitutes a disposition, and really no guidance at all where the assignment is by the obligor rather than the obligee. A body of cases address whether a *substitution* of obligors under an installment obligation results in a disposition for purposes of the installment sale rules. These authorities are not directly on point, since the assignment here does not involve a substitution of obligors. In a structured sale, the third party's payment obligation under the assignment is in addition to, not in substitution of, the buyer's original obligation to the seller. The buyer's liability to the seller is not extinguished. If a substitution of obligors (the old obligor being completely discharged and a new one substituted in its place) would not trigger a disposition, neither should an assignment.

Disposition Cases and Rulings

A leading case on this topic is *Wynne v. Comr.*[10] In *Wynne*, a corporation owned by a partnership owed remaining payments to a former shareholder under an installment obligation. The corporation was liquidated and the partnership assumed liability to make the remaining payments in accordance with the terms of the original obligation. Thus, the only change that occurred as a result of the liquidation was the substitution of a new obligor for the former obligor. The Board of Tax Appeals rejected the IRS's contention that a disposition of the installment obligation occurred.

Another leading case is *Cunningham v. Comr.*,[11] where a corporation bought the stock of another corporation for cash and promissory notes. The stock was then pledged as collateral for repayment of the promissory notes. Two years later, the corporation sold the stock to a new corporation, with the new corporation agreeing to assume liability under the promissory notes, and the original buyer released from any further liability.

Soon after this sale, the new buyer and sellers agreed to change the terms of the promissory note. The changes related to the amount and due dates for payments and a waiver of interest. The court rejected the IRS's contention that the second sale resulted in a disposition of the promissory notes for purposes of the installment sale rules, reasoning that the sellers had no more or less than they had in the beginning. They were creditors of the same installment obligations. There was a different obligor, it is true, but in both instances, the essential underlying security for the obligations was the stock and its earning potential.[12]

In Rev. Rul. 75-457,[13] the taxpayer sold real estate to a buyer in exchange for cash and a promissory note. One year later, the buyer sold the property to a new buyer, and the taxpayer agreed to release the first buyer from further liability and to substitute the new buyer as the obligor under the promissory note. The other terms of the note were not changed. The IRS held that the substitution of a new obligor did not trigger a disposition under the installment sale rules. The IRS stated: "The mere substitution and release of the original obligor on an installment obligation, and the

[7] *See* §453B(a)(1) and (2).

[8] 1975-2 C.B. 196, *amplified by* Rev. Rul. 82-122, 1982-1 C.B. 80.

[9] *See* Cliff & Levine, "Reflections on Ownership — Sales and Pledges of Installment Obligations," 39 *Tax Lawyer* 37 (1985).

[10] 47 B.T.A. 731 (1942).

[11] 44 T.C. 103 (1965).

[12] 44 T.C. at 108.

[13] 1975-2 C.B. 196, *amplified by* Rev. Rul. 82-122, 1982-1 C.B. 80.

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assumption of the installment obligation by a new obligor, without any other changes, will not in itself constitute a satisfaction or disposition under section 453(d)." [14]

GCM 36299 [15] contains a discussion of Rev. Rul. 75-457, which had focused on the rights of the seller. A disposition should not occur "as long as [the seller] possesses substantially the same rights he received in the original transaction." Based on that standard, the GCM concluded that a disposition does not occur merely on account of "a change in the identity of the obligor when the seller's rights under the installment sale otherwise were not altered."

The rationale of GCM 36299 and Rev. Rul. 75-457 differs somewhat from the reasoning suggested by Rev. Rul. 61-215.[16] In that earlier ruling, two corporations merged, and the surviving corporation assumed a liability under an installment agreement. The IRS held that the substitution of obligors that occurred as a result of the merger did not trigger a disposition of the note. The IRS reasoned that "there was, in essence, not a substitution of a new or materially different obligor or obligation."

This reasoning in Rev. Rul. 61-215 suggests that a disposition could be triggered if the new obligor is "materially different" in some sense from the original obligor. However, the IRS has not chosen to follow this aspect of Rev. Rul. 61-215. Rather, in both Rev. Rul. 75-457 and Rev. Rul. 82-122, the IRS focused solely on changes in the rights of the seller and ignored entirely the identity of the obligor.

In Rev. Rul. 82-122,[17] the IRS amplified its holding in Rev. Rul. 75-457.[18] The two rulings involved similar facts, except that in Rev. Rul. 82-122, in exchange for releasing the original buyer from further liability, the seller and the new buyer agreed to increase the interest rate and monthly payments under the assumed mortgage. The IRS concluded that the changes in the obligor and interest rate did not eliminate or materially alter the rights of the seller. Accordingly, the IRS held that the transaction did not result in a disposition.

The IRS and courts continue to adhere to the holdings in Rev. Rul. 75-457 and the *Cunningham* case. In a structured sale, the sole effect of the assignment is to impose a payment obligation on the third party that is in addition to, not in substitution for, the original payment obligation of the buyer under the agreement. The buyer is not released from liability. Apart from creating an additional obligation on the part of the third party, the assignment does not alter or affect the terms of the buyer's original obligation.

Constructive Receipt

The constructive receipt doctrine prohibits taxpayers from deliberately turning their backs on income and selecting the year in which they want to receive (and report) the income. Income is constructively received if it is credited to the taxpayer's account, set apart or otherwise made available so that the taxpayer can draw upon it.[19] There is no constructive receipt if the taxpayer's control is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available until some future date, the mere crediting on the corporate books does not constitute receipt.[20]

General constructive receipt rules seem to have no application to the structured sale. If a *buyer* assigns an obligation to pay periodic payments to a third party in an independent transaction, the *seller* should not have to accelerate its gain. The regulations define when income is constructively received by a taxpayer, but do not even suggest that rights under security instruments that protect installment sales reporting trigger constructive receipt.[21] Indeed, the Installment Sales Revision Act of 1980 allowed for security instruments (such as standby letters of credit) to be specifically exempt from any constructive receipt issues. A security instrument merely ensures the seller of funds, if the buyer or third party defaults.

Under traditional constructive receipt principles, if payments are not credited to a claimant's account, set apart for him or otherwise made available so he may draw upon the funds at any time, there is no constructive receipt. Therefore, if a buyer assigns obligations to pay periodic payments to a seller, the seller should not experience any acceleration of gain. The buyer's assignment of its payment obligation to a third party assignment company gives the seller no greater rights than the seller would have under a standby letter of credit.

Cash Equivalency

The cash equivalency doctrine essentially states that, if a promise to pay a benefit to an individual is unconditional and exchangeable for cash, then the promise is the same as cash and is currently taxable, even if that promise is unfunded. In *Cowden v.*

[14] *Id.*

[15] GCM 36299, I-106-75 (6/5/75); *see* GCM 39225, I-288-83 (4/25/84).

[16] 1961-2 C.B. 110.

[17] Rev. Rul. 82-122, 1982-1 C.B. 80.

[18] *See also* TAM 9238005; FSA 200125073.

[19] Regs. §1.451-2(a).

[20] *Id. See* PLR 7927001; *Comr. v. Tyler*, 28 B.T.A. 367 (1933).

[21] Regs. §1.451-2(a).

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Comr.,[22] the Fifth Circuit held that a contract right to deferred bonus payments under an oil and gas lease was the equivalent of cash. Thus, the court found that the right was currently taxable just as if cash had been received by the taxpayer.

The court based its conclusion on the following three factors: (1) the obligation of the payor was an unconditional and assignable promise to pay by a solvent obligor; (2) it was of a kind that was frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money; and (3) the obligation was readily convertible to cash.[23]

There are strong arguments why the cash equivalency doctrine should not be applied to structured sales. The case law exploring the cash equivalency doctrine focuses primarily on deferred payment obligations that the taxpayer can readily discount. That makes sense. Conversely, where a payee's rights cannot be assigned, transferred, pledged or encumbered, the cash equivalency doctrine has not been applied.[24]

In a properly planned structured sale, the documents will forbid the seller from transferring, assigning, selling or encumbering its rights to receive future payments. Any attempt by a seller to sell, transfer or assign its rights to future payments is void, thus precluding application of the cash equivalency doctrine. Again, it is the *buyer* who may choose to assign its obligations to a third party. That gives no extra rights to the stream of payments from the seller's perspective.

In a structured sale, the seller cannot convert the annuity into cash. The seller has no rights to the annuity. The seller is not even a party to the transaction between the buyer and the assignment company. A number of cases support the fundamental principle that, if the taxpayer cannot assign, transfer, pledge or encumber the asset or payment right, the cash equivalency doctrine does not apply.[25]

A structured sale merely adds another obligor to the mix. It does not release the original obligor, and it doesn't change *any* of the terms of the original note. The terms of the contract between the buyer/third party forbid the seller from transferring, assigning, selling or encumbering any of its rights to receive future payments. Any attempt by a seller to sell, transfer, or assign its rights to future payments is void, thus precluding application of the cash equivalency doctrine.

Economic Benefit Doctrine

The economic benefit doctrine is another bogeyman that should have no application here. Economic benefit occurs when money or property is not necessarily available so that the taxpayer may obtain it at any time, but rather has been transferred to an arrangement (such as a trust) for the sole economic benefit of the taxpayer. Rev. Rul. 60-31,[26] considers the economic benefit doctrine across an array of examples. Those examples discuss situations where there is more than a mere promise to pay, and the obligations are secured in some way.

The authorities contain no suggestion that a structured sale would run afoul of the economic benefit doctrine. For example, in *Sproull v. Comr.*,[27] an employer established an irrevocable trust for the benefit of the employee. The court held that the employee had received an economic benefit and, thus, the value of the trust was taxable. However, in *Sproull*, the taxpayer's rights in the trust were vested and secured, and the taxpayer was free to assign or alienate the trust proceeds. The ability to assign or alienate value is a key right.

In a structured sale, the seller is not a party to the transaction between the third party and the buyer. The seller has no rights in the annuity. Further, *Sproull* involved personal services, not a sale of property. In *Sproull*, the taxpayer's employer set up the trust in connection with the taxpayer's services.

Special scrutiny is appropriate with personal services. Indeed, §83 was enacted in 1969 to address property transferred in connection with the performance of services. While §83 may not have entirely preempted constructive receipt and economic benefit issues in the context of personal services, it does clearly suggest that there are special concerns present in the personal service context.

Personal services were also involved in *Childs v. Comr.*,[28] though in that case the taxpayers were found not to have an economic benefit. *Childs* addressed the question whether attorneys had the economic benefit of annuity policies purchased to fund periodic payments of their fees. The opinion states that the annuity policies were not secured because the policies were subject to claims of general creditors of the insurance companies (that sold the annuities). Therefore, the annuity was not taxable income to the attorneys when the annuity was purchased.

Childs is the seminal case on structuring attorneys' fees. The IRS has not acquiesced in *Childs*, although

[22] 289 F.2d 20 (5th Cir. 1961).

[23] *Cowden v. Comr.*, 289 F.2d 20 (5th Cir. 1961), *rev'g and rem'g* 32 T.C. 853 (1959), *on remand,* T.C. Memo 1961-229.

[24] *See Reed v. Comr.*, 723 F.2d 138 (1st Cir. 1983).

[25] *See, e.g., Reed v. Comr.*, 723 F.2d 138 (1st Cir. 1983); *Johnston v. Comr.*, 14 T.C. 560 (1950).

[26] 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121, *modified by* Rev. Rul. 70-435, 1970-2 C.B. 100.

[27] 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

[28] 103 T.C. 634 (1994), *aff'd* 89 F.3d 856 (11th Cir. 1996).

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interestingly enough, the IRS has cited *Childs* and relied upon it in several documents.[29] Whether the IRS is comfortable approving structures of personal service payments, the roadmap drawn by the *Childs* court does seem (to the author, at least) to be a clearly marked one that taxpayers may follow.

Of course, *Childs* involved personal services. In any personal service context, there is greater potential for constructive receipt concerns, since conceivably there could be arguments about the specific point in time at which the service provider becomes entitled to payment. When, after all, do attorneys' fees accrue? In the sale of property context, it is axiomatic that a taxpayer can refuse to sell except for installments over time, and that this refusal plainly does not invoke constructive receipt. A subsequent transaction between the *buyer* and a third party, which does not give the installment seller different terms but merely adds an obligor, should not invoke constructive receipt or economic benefit.

In a structured sale (which takes place after the conclusion of a sale transaction, not the performance of services), the third party's payments are not secured and do not replace the liability of the buyer to make the periodic payments. If the buyer was already bound by an installment agreement pursuant to which the payments are only taxable in the year received, the buyer's receipt of payments from a third party (whose obligation to make those payments are not secured) should not change the tax position of the seller.

The examples and discussions in Rev. Rul. 60-31 [30] apply the economic benefit doctrine in the context in which there is considerably more than a mere promise to pay and the obligations are secured. In a structured sale, the additional obligation of the assignment company to pay is not secured, i.e., the annuity and third party guaranty are merely in addition to the buyer's original obligation to pay. The buyer remains personally liable to the seller for all payments. While the presence of a third party obligor may provide additional peace-of-mind for the seller, there is no guarantee the third party will remain solvent. There is no alteration of the seller's rights.

[29] *See* FSA 200151003.

[30] 1960-1 C.B. 174.

Conclusion

Since the beginning of time — or the beginning of the income tax at least — taxpayers have wanted to defer their tax payment obligations. Deferral is practically a hallowed concept. Much of the lore of tax planning is based on it. Given the nearly primordial desire taxpayers have to postpone their tax obligations, there is a natural tension between this mantra and several fundamental tax concepts, including the annual accounting requirement and the constructive receipt and economic benefit doctrines.

Timing-of-income issues are central to our tax system. Just as central is the notion that there is nothing inappropriate about attempting to reduce one's tax liability as much as lawfully possible.[31] The installment method of reporting has never been at odds with the constructive receipt and economic benefit doctrines, precisely because one is fully entitled to arrange one's affairs so as to pay a reduced amount of tax. There is hardly anything with more economic substance than paying less tax because one receives less cash. As long as the installment seller conditions the sale on the execution of the installment note, thus firmly establishing the amounts and number of years over which the sale price is payable, there simply is no tax issue.

A structured sale involves an assignment by the obligor under the installment note of its duties to a third party who will then make payments to the seller. This does nothing to alter the series of events first set in place when the seller negotiated for installment payments. The installment payments remain the same, the interest rate remains the same, and the original obligor is still obligated under the note. The only thing that has changed — and not through documents to which the seller is a party — is that the buyer's assignment of its obligations produces an additional obligor, and a third party, such as an insurance company, makes a general promise to pay any payments coming due after it receives notice of the assignment company's default. Therefore, the basic installment sales reporting envisioned by the seller at the inception of the transaction should not be adversely affected by the additional facts introduced in the structured sale scenario.

[31] Judge Learned Hand said this memorably in *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

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