

REAL ESTATE NOTES, INSTALLMENT SALES, AND STRUCTURED SALES

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There are virtually limitless ways to dispose of real estate. This paper starts with the base case of a sale for cash, and discusses the tax rules of general application to taxable dispositions of property. It then explores several alternative sale structures designed to defer recognition of gain and payment of tax. One common tax deferral structure not analyzed in detail in this paper is a like-kind exchange, which is considered in a separate paper.

I. BASE CASE: SALE FOR CASH

A. Gain or Loss

In a sale of a fee interest in real estate for cash, the seller's gain or loss on the sale is equal to the difference between the amount realized and the seller's adjusted tax basis for the asset.¹ The amount realized includes money received plus the value of any property other than money received. The amount realized excludes amounts representing a reimbursement to the seller of property taxes paid by

¹ I.R.C. § 1001(a). Note that property acquired by gift can have a different tax basis for computation of gain than its tax basis for computation of loss. See I.R.C. § 1015(a).

the seller but treated for federal income tax purposes as imposed on the buyer,² and is reduced by selling expenses, such as brokerage commissions, legal fees, and title costs.³

The amount realized includes the amount of liabilities from which the seller is discharged from primary liability as a result of the sale, including nonrecourse liabilities secured solely by the property sold.⁴ For this purpose, the value of the security for a liability is generally not relevant.⁵ However, in the case of a transfer of property to a lender in satisfaction of a recourse debt, the amount realized is limited to the value of the property transferred, and the balance of the debt is treated as income from the discharge of indebtedness rather than gain from the sale of property.⁶

Gain or loss from the sale of property is generally recognized in the year of sale.⁷ There are numerous nonrecognition provisions. The provisions for nonrecognition of gain generally relate to circumstances in which the taxpayer has not “monetized” its investment, and generally provide for deferral rather than exclusion of the gain. A sale for cash would rarely qualify for nonrecognition of gain, with two notable exceptions being (1) the partial exclusion of gain from the sale of a principal residence,⁸ and the (2) deferral of gain from involuntary conversions.⁹ The provisions for nonrecognition of loss generally relate to disallowance of losses on property held for personal use rather than for investment or use in a trade or business,¹⁰ or to sales of property to related persons,¹¹ and may provide for permanent disallowance or temporary deferral of the loss.

² I.R.C. § 1001(b).

³ *Cf.* Treas. Reg. § 1.263(a)-2 (commissions paid in selling securities reduce amount realized, except in the case of commissions incurred in dealer transactions). A problem can arise when a cash basis taxpayer has selling expenses that are not paid until the year after the year in which the sale occurs. *See generally* Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 43.1 (WG&L 2008).

⁴ Treas. Reg. § 1.1001-2(a)(1).

⁵ Treas. Reg. § 1.1001-2(b).

⁶ Treas. Reg. § 1.1001-2(a)(2).

⁷ I.R.C. § 1001(c).

⁸ I.R.C. § 121.

⁹ I.R.C. § 1033. *See also* I.R.C. § 1038 (deferral of gain on certain reacquisitions of real property in satisfaction of purchase money debt).

¹⁰ I.R.C. § 165.

¹¹ I.R.C. § 267.

B. Character of Gain or Loss

1. Capital Gain or Loss

In the case of individuals, gain from sales of “capital assets” held for more than one year (“long-term capital gains”) are currently eligible for a reduced maximum tax rate of 15%.¹² Taxable corporations are taxed at a maximum 35% tax rate on both ordinary income and capital gains.

To determine an individual’s gain subject to the 15% maximum tax rate, the taxpayer must first offset long-term capital losses against long-term capital gains, and short-term capital losses against short-term capital gains. If the net long-term capital gain exceeds any net short-term capital loss, the taxpayer has a net capital gain.¹³ From net capital gain, the taxpayer must deduct unrecaptured section 1250 gain (discussed below, and sometimes referred to as 25% rate gain) and 28% rate gain (gain on collectibles and small business stock), and add qualified dividend income, to arrive at “adjusted net capital gain.” Adjusted net capital gain is taxed at the 15% maximum tax rate. Any excess of capital losses over capital gains is not currently deductible (except to the extent of \$3,000 in the case of non-corporate taxpayers), but may be carried to other years.¹⁴

The term “capital asset” means all property other than, among other assets, (1) dealer property (i.e., property held primarily for sale to customers in the ordinary course of business, such as most subdivided real estate developments), and (2) depreciable and real property used in a trade or business. Consequently, real estate used in a business generally cannot qualify as a capital asset. However, real estate held for investment or personal use can qualify as a capital asset.

Gain from the sale of a capital asset does not include gain that is treated as ordinary income, including gain treated as ordinary income under the depreciation recapture rules (discussed below).¹⁵

2. Section 1231 Gains and Losses

Although real estate used in a business cannot qualify as a capital asset, it can qualify for long-term capital gain treatment under the special rules of Section 1231.¹⁶ Under Section 1231, all gains and losses from business property held for more than one year (other than dealer property) and from involuntary conversions are netted and if the net result is a gain, all the gains and losses are treated as long-term capital gains or losses and are included in the calculation of net capital gain eligible for the 15% tax rate. If the net result of the Section 1231 gains and losses is a net loss, all the Section 1231

¹² I.R.C. § 1(h).

¹³ I.R.C. § 1222.

¹⁴ I.R.C. § 1211, 1212.

¹⁵ I.R.C. § 64.

¹⁶ References to “Section” in text refer to the Internal Revenue Code of 1986, as amended.

gains and losses are treated as ordinary gains (income) or losses. Thus, Section 1231 assets receive highly favorable treatment under the Internal Revenue Code.

To prevent taxpayers from timing gains and losses on Section 1231 property to circumvent the Section 1231 netting scheme, if a taxpayer has a net Section 1231 loss in one year, and a net Section 1231 gain in a subsequent year, the net Section 1231 gain is treated as ordinary income to the extent it does not exceed the non-recaptured net section 1231 losses from prior years.¹⁷

As in the case of capital assets generally, Section 1231 gains do not include amounts treated as ordinary income, including gain treated as ordinary income under the depreciation recapture rules (discussed below).¹⁸

3. *Depreciation Recapture*

Section 1245 generally provides that gain on the sale of certain depreciable property is treated as ordinary income to the extent of prior depreciation or amortization deductions. Section 1245 applies to depreciable personal property and specified types of depreciable real property.

Section 1250 generally provides that gain on the sale of depreciable real property (other than section 1245 property) is treated as ordinary income to the extent of prior depreciation adjustments, except that for property held for more than one year, only depreciation adjustments that exceed straight-line depreciation are taken into account.¹⁹ In addition, in the case of a corporation, 20% of any straight-line depreciation recapture is treated as ordinary income.²⁰

Most real property is not classified as section 1245 property, and real property placed in service after 1986 is not eligible for accelerated depreciation. Therefore, section 1250 has limited application. It principally relates to commercial realty acquired during 1981 through 1986, and depreciable real property of all types acquired before 1981.

4. *Unrecaptured Section 1250 gain*

The amount of long-term capital gain from the sale of section 1250 property is subject to a 25% maximum tax rate (and is excluded from net capital gain eligible for the 15% maximum tax rate) to the extent of depreciation adjustments not recaptured under section 1250.²¹

¹⁷ I.R.C. § 1231(c). The statute does not explain how the recharacterized gain is apportioned among Section 1231 gains and losses for the subsequent year when there are multiple Section 1231 properties sold during the year.

¹⁸ I.R.C. § 64.

¹⁹ The theory of recapturing only accelerated depreciation on real estate is that it is a rough proxy for eliminating tax on gain that is attributable to inflation rather than to excess depreciation. Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 51.1 (WG&L 2008) (discussion at n.6).

²⁰ I.R.C. § 291(a)(1).

²¹ I.R.C. § 1(h)(6).

5. *Sale to Related Parties*

If depreciable property is sold to a related person, the gain is reclassified as ordinary income.²² For this purpose, a related person is any controlled entity, a trust in which the taxpayer or the taxpayer's spouse is a beneficiary (other than a remote contingent interest), and an estate and a beneficiary of the estate (except in the case of satisfaction of a pecuniary bequest). A controlled entity is generally an entity in which the taxpayer holds, directly or indirectly, a 50% or more interest.

6. *Subdivided Real Property Held for Investment*

Ordinarily, a taxpayer that subdivides a tract of land for the purpose of actively selling lots is deemed to hold the lots primarily for sale to customers in the ordinary course of business, and therefore the lots constitute dealer property that is not eligible for capital gain treatment. Section 1237 provides a special rule whereby a taxpayer may be treated as not holding the tract or lots as dealer property. To obtain this treatment the taxpayer must not have previously held the tract or lots as dealer property, must not otherwise be a dealer in real estate for the taxable year of the sale, must not have made a substantial improvement in the property, and must have held the property for 5 years. In such cases the first five sales may be made subject only to capital gain or loss treatment. In the year in which the sixth sale is made, and in any subsequent sales of the property, the taxpayer is to report 5 percent of his gross proceeds of all such sales as ordinary income and any remaining gain as capital gain.

7. *Holding Period*

The holding period for property acquired for cash in a taxable transaction generally excludes the acquisition date and includes the disposition date.²³ A single property may have more than one holding period. For example, a person who purchases vacant land and then constructs a building on the land will have one holding period for the land and a different holding period for the building. Moreover, the acquisition of a building constructed by the taxpayer is treated as occurring progressively over the construction period such that a portion of the building can have a more than one year holding period and a portion of the building can have a holding period of less than one year.²⁴

The date of sale (or disposition) is generally the date that title passes to the buyer, but this is not a hard and fast rule and all the facts and circumstances surrounding the transaction must be examined to determine when the benefits and burdens of ownership passed from the seller to the buyer taking into account the legal consequence of the contract provisions and applicable state law.²⁵ Where all material

²² I.R.C. § 1239(a).

²³ See, *Fogel v. Commissioner*, 203 F.2d 347 (5th Cir. 1953) (grain futures contract); Rev. Rul. 70-598, 1970-2 C.B. 168 (securities).

²⁴ Rev. Rul. 75-524, 1975-2 C.B. 342.

²⁵ *Hoven v. Commissioner*, 56 T.C. 50 (1971).

conditions to the sale have been satisfied and the buyer has taken possession of the property, the sale may be deemed to occur prior to physical passage of title.²⁶ This is the rule for land contract sales.²⁷

8. *Timing of Sale*

Even in the case of a sale for cash, the timing of the sale can have significant effects on the timing of the payment of any tax due on the gain from the sale. A sale on December 31, 2008 will generally result in tax being due on April 15, 2009 at the latest. And the tax might have to be paid on January 15, 2009 to avoid an estimated tax penalty.²⁸ In contrast, if the sale is delayed one day, to January 1, 2009, it might be possible to delay the tax payment one full year (or more) until April 15, 2010. This assumes that estimated tax payments for 2009 on other income would be based on tax paid for 2008 such that the gain on sale does not increase the taxpayer's 2009 estimated tax payments. Even if the taxpayer is not using the exception for last year's tax (such as a C corporation), deferring the gain to the beginning of the 2009 tax year might allow the taxpayer to spread out the tax payments over the 2009 tax year rather than paying all the tax due on April 15.

Even within a tax year, delaying a sale from the end of a month that marks the end of an estimated tax period to the beginning of the following month can defer estimated tax payments if the taxpayer is basing estimated taxes on annualized income.

II. **INSTALLMENT SALES**

This section considers a sale transaction in which the consideration is not solely cash, but includes a buyer note or other deferred payment obligation.

A. **In General**

If a taxpayer sells property in a transaction in which at least one payment is to be received after the close of the taxable year in which the sale occurs (an "installment sale"), the gain (if any) from the transaction is reported under the installment method, subject to certain exceptions and limitations discussed below.²⁹ Under the installment method, the amount of income recognized by the taxpayer in a taxable year with respect to the installment sale is generally equal to the payments received in that year attributable to the sale multiplied by gross profit ratio for the sale. The gross profit ratio for a sale is (a) the selling price for the property less Seller's adjusted tax basis for the property, divided by (b) the total contract price (i.e., selling price minus any qualifying indebtedness that does not exceed the seller's

²⁶ *Snider v. Commissioner*, 453 F.2d 501 (5th Cir. 1972).

²⁷ *Kindschi v. Commissioner*, T.C. Memo 1979-489.

²⁸ I.R.C. § 6654, 6655.

²⁹ I.R.C. § 453. See generally, Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1 (WG&L 2008); Starczewski, *Installment Sales*, 565-2d Tax Mgmt. Portfolios (BNA).

basis). For this purpose, selling expenses are not subtracted from the selling price, but are instead added to basis.³⁰ The basic installment method formula can be expressed as follows:

- Gain = payment received x gross profit ratio
- Gross profit ratio = (selling price – basis and selling expenses) ÷ contract price

Example 1: S sells property subject to a \$20 nonrecourse debt for \$100 cash, with \$80 to be paid at closing and \$20 to be paid one year later. The property has a basis of \$50.

The tax due is calculated as follows:

- Selling price = \$120 (\$100 cash + \$20 debt discharged)
- Contract price = \$100 (selling price - \$20 qualifying indebtedness)
- Gross profit ratio (GPR) = (\$120 selling price - \$50 basis) ÷ \$100 contract price = 70%
- Gain at closing = \$56 (\$80 payment x 70% GPR)
- Gain in year 2 = \$14 (\$20 payment x 70% GPR)

The effect is that S's \$50 basis (inclusive of selling expenses) has first been allocated to the amount of qualifying indebtedness assumed in the transaction (\$20), and the remaining \$30 of basis has then been spread to the sale payment and deferred payment in proportion to the amount of each payment.³¹ Gain is recognized only as payments are received.

B. Exceptions

Certain transactions are not eligible for installment method reporting, including

- sales of publicly traded securities;³²
- “dealer dispositions” and sales of inventory;³³
- certain sales of depreciable property to controlled entities;³⁴
- sales of depreciable property to the extent of depreciation recapture;³⁵ and
- accounts receivable arising from sales of inventory³⁶ or from services rendered.³⁷

³⁰ I.R.C. § 453(c); Treas. Reg. § 15a.453-1(b)(2).

³¹ The date of sale payment represents 80% of the total payments to be received ($\$80 \div (\$80 + \$20) = 80\%$). Accordingly, 80% of the \$30 remaining basis is allocated to the \$80 date of sale payment, resulting in date of sale gain of \$56. The deferred payment represents 20% of the total payments, and is allocated \$7 of basis ($20\% \times \$30 \text{ basis} = \7).

³² I.R.C. § 453(k)(2)(B). This provision can be easily overlooked because subsection (k) is titled “Current inclusion in case of revolving credit plans, etc.”

³³ I.R.C. § 453(b)(2), (l).

³⁴ I.R.C. § 453(g). A controlled entity is defined as under I.R.C. § 1239, which generally uses a greater than 50% ownership test. The exception for sales to controlled entities is intended to prevent situations in which the controlled entity includes the deferred payment obligation in its depreciable basis for the property and its depreciation deductions are recognized substantially sooner than the seller's corresponding gain recognition. The exception is not applicable if the parties can demonstrate that the sale does not have tax avoidance as one of its principal purposes (i.e., no tax deferral benefits). See Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1.11 (WG&L 2008).

³⁵ I.R.C. § 453(i).

In addition, a taxpayer can elect out of the installment method.³⁸ The consequences of an election out of the installment method are discussed in paragraph F below. For special rules relating to sales of farming property, timeshares, campground rights, and residential lots, see paragraph E(10) below.

C. Payment Defined

The seller's receipt of the buyer's obligation to make deferred payments under the sale contract (e.g., in the form of an installment note) generally does not constitute receipt of a "payment." Instead, the seller's subsequent receipt of the payments due under the buyer's deferred payment obligation constitute receipt of payments. However, if the deferred payment obligation is payable on demand or is readily tradable, or if it is secured by cash or cash equivalents, the seller's receipt of the obligation constitutes a payment, and the transaction may fail to qualify as an installment sale (if there are no other deferred payments). An obligation of a person other than the buyer is also treated as a payment. A qualified indebtedness assumed by the buyer is a payment only to the extent it exceeds the seller's basis for the property.³⁹

Amounts paid by Buyer into an escrow account to secure Seller's obligation to indemnify Buyer against breaches of representations and warranties or other events specified in the sale contract can be reported by Seller under the installment method (if the method is otherwise applicable) even though the escrow is not technically an obligation of the buyer.⁴⁰

Amounts received in the form of like-kind property permitted to be received without recognition of gain under Section 1031 are generally not treated as payments under the contract.⁴¹ See the

³⁶ *Berger v. Commissioner*, T.C. Memo 1996-76 (RIA) (I.R.C. § 453(b) proscription on installment reporting for inventory extended to sale of accounts receivable because it would be "anomalous" to allow the sale of receivables to be entitled to § 453 installment sale treatment when the sale of the inventory that generated the receivables was not eligible for installment sale treatment).

³⁷ *Sorensen v Commissioner*, 22 T.C. 321 (1954) (sale of compensatory stock options not eligible for installment method because sale proceeds constituted compensation for services not income arising from the sale of property on the installment basis); CCA 200722027 (June 1, 2007) (sale of partnership interest ineligible for installment method reporting to the extent sale proceeds are attributable to the partner's share of partnership rights to payment for services rendered). *Compare Realty Loan Corp. v. Commissioner*, 478 F.2d 1049 (9th Cir. 1973) (rights to payment for services to be rendered in the future with respect to mortgages can be sold on the installment method).

³⁸ I.R.C. § 453(d). See discussion in paragraph F below.

³⁹ Treas. Reg. § 15a.453-1(b)(3)(i). For the effect of this springing basis on buyer's depreciation calculations, see Treas. Reg. § 1.168-2(d)(3).

⁴⁰ IRS Publication 537 (2005), *Installment Sales* p. 6 ("If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of Buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on Buyer."). See also Ltr. Rul. 200521007 (Feb. 25, 2005); Ltr. Rul. 8645029 (Aug. 8, 1986); Ltr. Rul. 8629038 (April 18, 1986). See generally Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* ¶ 203.5.4 (Jan. 2006).

⁴¹ I.R.C. § 453(f)(6)(C).

discussion in paragraph G below regarding overlap between the installment sale rules and the like-kind exchange rules.

D. Contingent Payment Obligations

1. Stated Maximum Selling Price

Where property is sold in exchange for an obligation providing for contingent payments (a “contingent payment sale”), if the maximum amount of sale proceeds that may be received by Seller can be determined by the end of the year in which the sale occurs, the selling price and total contract price will be determined by treating the maximum amount of sale proceeds as the selling price. If the maximum amount is subsequently reduced, the gross profit ratio is recomputed with respect to payments received in or after the taxable year in which the event requiring reduction occurs.⁴² A loss deduction is allowed for any excess of the taxpayer’s unrecovered basis (inclusive of selling expenses) for the property sold over the unpaid portion of the redetermined maximum selling price.⁴³

2. Fixed Period

When a maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent payment obligation is fixed, the taxpayer’s basis (inclusive of selling expenses) is generally allocated to the taxable years in which payment may be received in equal annual increments. However, if the terms of the agreement incorporate varying fixed or contingent payments such that the payments are not expected to be equal for all taxable years, basis must be allocated in accordance with the varying payment terms. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss is allowed and the disallowed loss is carried forward to the next succeeding taxable year unless the taxable year is the final payment year under the agreement or unless the future payment obligation has become worthless.⁴⁴

3. No Maximum Selling Price or Period

If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, basis (inclusive of selling expenses) is generally allocated in equal annual increments over 15 years. No loss is allowed for any year unless the future payment obligation has become worthless; instead the excess basis is reallocated in level amounts over the balance of the 15 year term. Any basis not

⁴² Treas. Reg. § 15a.453-1(c)(2)(i). If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule applies. *See* Treas. Reg. § 15a.453-1(c)(7).

⁴³ *See* Treas. Reg. § 15a.453-1(c)(2)(iii) Ex. (5).

⁴⁴ Treas. Reg. § 15a.453-1(c)(3).

recovered at the end of the 15th year is carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless.⁴⁵

4. *Alternative Methods*

If the taxpayer can demonstrate that the applicable method described above for a contingent payment sale would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer can use an alternative method of basis recovery ("alternative allocation method").⁴⁶ The taxpayer must show that the proposed alternative allocation method is reasonable and will likely recover basis twice as fast as the otherwise applicable method. The taxpayer must receive a ruling from the IRS before the alternative allocation method can be used. In addition, if the IRS determines that the otherwise applicable method would substantially and inappropriately accelerate basis recovery, the IRS can require a taxpayer to use an alternative allocation method. The IRS must show that its method is reasonable and that the normal method would result in basis recovery twice as fast as under the proposed alternative method. Normally, the taxpayer must request a ruling prior to the due date (including extensions) for the taxable year in which the first payment is received. However, if during the term of an agreement circumstances show that continued reporting on the normal method will substantially and inappropriately defer basis, the taxpayer can request a ruling at that time. Likewise, the IRS can require an alternative allocation method to taxable years other than the taxable year in which the first payment is received.⁴⁷

Except in the possible case of an alternative allocation method described in the preceding paragraph, the nature and productivity of the property sold is generally not independently relevant to the basis to be recovered in any payment year. However, an income forecast method is provided when the property sold is depreciable property of a type normally eligible for depreciation on the income forecast method (e.g., films), or is depletable property of a type normally eligible for cost depletion in which total future production must be estimated, and payments under the contingent selling price agreement are based upon receipts or units produced by or from the property, the taxpayer's basis may appropriately be recovered by using an income forecast method. Under the income forecast method, basis is spread to each payment received based on the ratio of the payment received to the forecasted total payments to be received. The forecast is adjusted at the end of each year and applied to payments

⁴⁵ Treas. Reg. § 15a.453-1(c)(4). The regulations provide that such transactions will be carefully scrutinized to determine whether there has been a bona fide sale rather than some other form of transaction.

⁴⁶ Treas. Reg. § 15a.453-1(c)(2), (3), (4), (7).

⁴⁷ Treas. Reg. § 15a.453-1(c)(7).

received during that year. No loss is allowed until the final payment year or until the future payment obligation has become worthless.⁴⁸

E. Limitations and Special Rules

1. Interest Charge on Large Sales

If the sales price for any property reported under the installment method exceeds \$150,000 (a “material installment sale”), and if the total face amount of obligations outstanding at the end of a taxable year arising from material installment sales during such taxable year exceeds \$5,000,000, the taxpayer is required to pay an interest charge on the tax deferred under the installment method.⁴⁹ The effect is to allow the payment of tax to be deferred until cash is received, but to require payment of an interest charge on the deferred tax amounts.

2. Anti-Pledging Rules

To the extent a taxpayer pledges an installment obligation as security for any borrowing, the amount borrowed is treated as a payment on the installment obligation.⁵⁰

3. Related Party Transactions

If a taxpayer sells property to a related person under the installment method (first disposition), and within two years of the first disposition and before the taxpayer receives all payments with respect to the first disposition, the related person sells the property (second disposition), then the amount realized on the second disposition is treated as realized at that time by the taxpayer with respect to the first disposition. This rule does not apply if it is established that neither disposition had tax avoidance as one of its principal purposes. Various special rules and exceptions apply.⁵¹

As noted above, sales of depreciable property to controlled entities are not eligible for the installment method unless the taxpayer can establish that there is no tax avoidance.⁵² The general effect is that the seller must recognize all deferred payments in income at the time of sale, including the fair market value of any contingent payment obligations. In cases where the payments are contingent as to amount and cannot be valued, the seller’s basis must be “recovered ratably.” There is no guidance on the period or method for ratable recovery, but presumably basis may be recovered in accordance with the rules for contingent payment obligations discussed above (i.e., over the maximum period for the

⁴⁸ Treas. Reg. § 15a.453-1(c)(6).

⁴⁹ I.R.C. § 453A(a)(1).

⁵⁰ I.R.C. § 453A(d).

⁵¹ I.R.C. § 453(e). Related person is defined for this purpose in I.R.C. § 453(f)(1), and generally means persons whose stock would be attributed to the taxpayer under I.R.C. § 318(a) or who are related to the taxpayer under I.R.C. § 267(b).

⁵² I.R.C. § 453(g).

contingent payments, 15 years, or some alternative method approved by the IRS). The buyer cannot increase its basis in the property before the time the amount is included in the seller's income.⁵³

4. *Dispositions of Installment Obligations*

A disposition of an installment obligation will generally accelerate any deferred gain.⁵⁴ An important exception is provide for certain transfers of installment obligations held by an S corporation in a complete liquidation of the corporation following an installment sale of its assets. The corporation recognizes generally no gain or loss on the distribution of the obligation.⁵⁵

If a shareholder in a C corporation receives an installment obligation in a taxable complete liquidation of the corporation and the obligation arises from the sale of the corporation's assets during the 12-month period beginning with the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period, then for purposes of computing the shareholder's gain on the liquidation, the receipt of payments under the obligation (but not the receipt of the obligation) are treated as payments for the shareholder's stock.⁵⁶

If an installment obligation is cancelled or becomes unenforceable, the seller must nevertheless report the excess of the fair market value of the note over the unrecovered basis of the property in the seller's income in the year the obligation is cancelled or becomes unenforceable. If the seller and buyer are related, the fair market value of the installment obligation is not less than its face amount. This rule is intended to prevent the seller from avoiding recognizing gain where the buyer has included the obligation in its basis for the property.⁵⁷

If property sold under an installment sale is repossessed, the transaction is generally treated as a taxable exchange of the installment obligation for the property, and the seller repossessing the property must recognize gain or loss in an amount equal to the difference between the fair market value of the repossessed property and the seller's basis in the installment note (i.e., the seller's unrecovered basis for

⁵³ I.R.C. § 453(g)(1)(C).

⁵⁴ I.R.C. § 453B. A gift of the deferred payment obligation is a disposition. Rev. Rul. 67-167, 1967-1 C.B. 107 (gift to non-grantor trust taxed as disposition). A transfer of a deferred payment obligation, other than to the obligor/buyer, by reason of death is not a disposition. I.R.C. § 453(c). A distribution in complete liquidation to a 80% or more corporate shareholder under I.R.C. § 337(a) is not a disposition. I.R.C. § 453B(d). A transfer to a spouse incident to a divorce is generally not a disposition. I.R.C. § 453B(g). Certain other nonrecognition provisions may also override I.R.C. § 453B. See Treas. Reg. § 1.453-9(c)(2) (exceptions for transfers to corporations under I.R.C. § 351, transfers to partnerships under I.R.C. § 721, and transfers by a partnership to a partner under I.R.C. § 731). Although these regulations were promulgated under the pre-1980 version of the statute, they have not been revoked and are consistent with the intent of current I.R.C. § 453B. See Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1.13 (WG&L 2008), discussion at n.195.

⁵⁵ I.R.C. § 453B(h).

⁵⁶ I.R.C. § 453(h).

⁵⁷ I.R.C. § 453B(f).

the property sold in the installment sale).⁵⁸ The character of the gain or loss is determined by reference to the character of gain or loss on the installment sale.⁵⁹ An exception is provided for repossessed real property.⁶⁰

5. *Qualifying Indebtedness*

As noted above, liabilities assumed by the buyer – to the extent the liabilities constitute “qualifying indebtedness” – receive preferred treatment under the installment method: consideration received in the form of transferred qualifying indebtedness is offset against basis and generally does not result in gain recognition; gain is generally recognized only on consideration received in the form of cash or other property.⁶¹ The term qualifying indebtedness means “a mortgage or other indebtedness encumbering the property and indebtedness ... incurred or assumed by the purchaser incident to the purchaser’s acquisition, holding, or operation in the ordinary course of business or investment, of the property.”⁶² Qualifying indebtedness does not include obligations for selling expenses or debt functionally unrelated to the property.⁶³

An anti-avoidance rule excludes debt incurred in contemplation of sale of the property if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.⁶⁴ This is a concern because debt proceeds are treated entirely as a recovery of basis, whereas cash paid by the buyer at closing receives only a proportionate allocation of basis.

6. *Liabilities in Excess of Basis*

As illustrated above, the installment method ordinarily allows qualifying indebtedness to be transferred without recognition of gain, and the seller’s gain is spread over the cash payments to be received by the seller. This rule does not work where the gain exceeds the amount of the cash payments; i.e., when the qualifying indebtedness exceeds the seller’s tax basis. To address those situations, the regulations provide that the amount of qualifying indebtedness in excess of seller’s tax basis is treated as a cash payment in the year of sale.⁶⁵

⁵⁸ See Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1.13, n.200 (WG&L 2008).

⁵⁹ I.R.C. § 453B(a).

⁶⁰ I.R.C. § 1038.

⁶¹ See discussion below for an exception where qualifying indebtedness exceeds the seller’s basis in the property transferred.

⁶² Treas. Reg. § 15a.453-1(b)(2)(iv). This definition would literally include debt that the buyer “incurred” with respect to the property, even if seller has no knowledge of the debt or even if the debt is incurred well after the acquisition from seller.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Treas. Reg. § 15a.453-1(b)(2)(iii), (3)(i).

Example 2: S sells property subject to a \$50 nonrecourse debt for \$50 cash, with \$20 to be paid at closing and \$30 to be paid pursuant to a five year installment note. The property has a basis of \$40.

The gross profit is \$60 (\$50 cash plus \$50 debt assumed minus \$40 tax basis), but the total cash payments are only \$50. Instead of applying a gross profit ratio of 120% to the cash payments, the regulations treat the excess of qualifying indebtedness (\$50) over tax basis (\$40) as a cash payment in the year of sale. This results in deemed cash payments of \$60 (\$30 in the year of sale, and \$30 pursuant to the installment note), and a gross profit ratio of 100%. S recognizes \$30 of gain in the year of sale.

7. *Wrapped Indebtedness*

A seller may be able to circumvent the rule relating to liabilities in excess of basis by not transferring the debt and instead having the buyer make the payments due under the seller's debt.

Example 3: The facts are the same as in the example 2 above, except buyer does not assume or take the property to S's \$50 debt, and instead agrees to buy the property for \$100 cash, with \$20 to be paid at closing and \$80 to be paid pursuant to a five year installment note. The payments under buyer's installment note are used in part to retire seller's \$50 debt.

Under the normal installment sale rules, S would recognize the \$60 gross profit (\$100 selling price - \$40 basis) ratably over the \$100 cash payments. S would recognize \$12 of gain in the year of sale (60% gross profit ratio x \$20 down payment), and \$48 over the life of the buyer's installment note.

To prevent this result, the Treasury regulations contain a special rule for wrap-around mortgages. A wrap-around mortgage is "an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property ("wrapped indebtedness") and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness."⁶⁶ Under the special rule for wrap-around mortgages, the wrapped indebtedness is deemed to be assumed by the buyer. In the example above, the buyer would be treated as taking the property subject to S's \$50 debt. As a result, S has a gross profit ratio of 100% (((\$100 selling price - \$40 basis) ÷ (\$100 selling price - \$40 debt not in excess of basis)), and recognizes \$30 of gain in the year of sale (\$20 down payment + \$10 debt in excess of basis). This is the same result in the previous example in which buyer expressly assumed the seller's debt. However, if the 100% gross profit ratio were applied to the remaining payments on buyer's installment obligation, S would recognize too much gain. To avoid this result, the regulations provide that S has basis in the buyer's \$50 wrap-around installment obligation equal to S's basis in the property (\$40), increased by the gain recognized in the year of sale (\$30), decreased by the cash and value of

⁶⁶ Treas. Reg. § 15a.453-1(b)(3)(ii).

non-qualifying property received in the year of sale (\$20), and that S's gross profit ratio for the payments due under the buyer's wrap-around installment obligation is a fraction, the numerator of which is the face amount of the obligation (\$50) less the taxpayer's basis in the obligation (\$50), and the denominator of which is the face value of the obligation (\$50). Under the facts of example 3, S has a 0% gross profit ratio for the \$50 wrap-around installment obligation, and a 100% gross profit ratio for the remaining \$30 of payments due under buyer's installment obligation. Accordingly, S will recognize the \$60 of gain (gross profit) \$30 in the year of sale and \$30 over the life of the buyer's installment note; the same result as under the facts above where the buyer assumed S's debt on the property.

Because the effect of the wrap-around mortgage regulation is to cause S to have two gross profit ratios – one with respect to the non-wrap-around payments and another with respect to the remaining payments – the Tax Court has held the regulation to be invalid on the ground that the statute contemplates only one gross profit ratio for the entire transaction.⁶⁷ However, the regulation is invalid only with respect to situations in which the buyer both in form and in substance does not assume seller's debt. For example, if arrangements are made for buyer to make payments directly to seller's lender, the transaction is likely to be viewed as effecting a transfer of the debt.⁶⁸

8. *Buyer Pays Selling Expenses*

Some taxpayers try to minimize year of sale taxes by having the buyer pay the seller's selling expenses.

Example 4: S sells property subject to a \$20 nonrecourse debt for \$100 cash, with \$20 to be paid at closing and \$80 to be paid in \$20 installments in years 2 through 5. The property has a basis of \$50. S pays a commission of \$10 on the sale.

S has a gross profit of \$60 (\$120 selling price – \$50 basis + \$10 selling expenses), and a gross profit ratio of 60% (\$60 gross profit ÷ (\$120 selling price – \$20 qualifying indebtedness⁶⁹)). S recognizes a \$12 gain in year 1, and a \$12 gain in years 2 through 5.

If instead of S using cash from buyer to pay the commission on the sale, the parties arranged for buyer to incur and pay the commission directly (reducing the year 1 payment to S from \$20 to \$10), S

⁶⁷ *Professional Equities v. Commissioner*, 89 T.C. 165 (1987).

⁶⁸ *Waldrep v. Commissioner*, 52 T.C. 640 (1969), *aff'd per curiam*, 428 F.2d 1216 (5th Cir. 1970) (buyer's execution of mortgage note to lender treated as tantamount to assumption of seller's mortgage obligation to lender); *Voight v. Commissioner*, 68 T.C. 99 (1977), *aff'd per curiam*, 614 F.2d 94 (5th Cir. 1980) (buyer guaranteed payment of wrapped mortgage to mortgagee and, under note to seller, had right to remit note payments directly to holder of wrapped mortgage to cover mortgage payments; this right was exercised; held, buyer assumed mortgage); *Lichtman v. Commissioner*, 44 T.C.M. (CCH) 1536 (1982) (on facts, buyer took subject to mortgages; clause in agreement purporting to require seller to continue to make mortgage payments was "simply part of the facade" of lease instead of sale, designed to avoid due-on-sale clauses of mortgages; in fact, payments were made by buyer). *Goodman v. Commissioner*, 74 T.C. 684 (1980), *aff'd without published opinion*, 673 F.2d 1332 (7th Cir. 1981).

⁶⁹ As noted above, seller's obligations incurred incident to the sale, such as commissions and other selling expenses, are not qualifying indebtedness. Treas. Reg. § 15a.453-1(b)(2)(iv).

achieves a better tax result on what is an economically identical transaction. S's gross profit is still \$60 (\$110 selling price – \$50 basis), but the gross profit ratio increases to 66.66% (\$60 gross profit ÷ (\$110 selling price – \$20 qualifying indebtedness)). S recognizes a gain of only \$6.66 in year one (\$10 payment x 66.66% gross profit ratio), and a gain of \$13.33 in years 2 through 5 (\$20 payment x 66.66% gross profit ratio). Obviously, this result will be sustained only where it is clear that the selling expenses are in substance direct obligations of buyer, and not seller obligations merely paid by buyer for seller's benefit.⁷⁰

9. *Unrecaptured Section 1250 Gain*

If gain from an installment sale gives rise to both unrecaptured section 1250 gain (25% rate gain) and adjusted net capital gain (15% rate gain), the unrecaptured section 1250 gain is taken into account before the adjusted net capital gain. For this purpose, unrecaptured section 1250 gain is first reduced by any net section 1231 loss recapture.⁷¹

10. *Farming Property, Timeshares, Campground Rights, and Residential Lots*

A dealer disposition, which is not eligible for installment method reporting, generally includes any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.⁷² Exceptions are provided for property used or produced in the trade or business of farming, timeshares used for no more than six weeks per year, rights to use specified campgrounds, and residential lots that the dealer does not improve. Sales of timeshares, rights to campgrounds, and residential lots qualify only if the buyer is an individual and is not guaranteed by any person other than an individual. Dealers who elect to report sales of timeshares and residential lots on the installment method must agree to pay interest on the deferred tax.⁷³

11. *Purchase Price Allocation*

If a sale involves multiple properties and some portion of the purchase price is paid at closing and a portion of the purchase price is paid in the form of deferred payment obligations (fixed or contingent) or escrow payments, it may be possible to allocate the deferred payment obligations exclusively to property eligible for the installment method and thereby maximize the gain deferred in the transaction.

There is authority for the position that the transferor and the transferee can agree to allocate specific forms of consideration to specific items of transferred property if the allocation is

⁷⁰ Rev. Rul. 76-109, 1976-1 C.B. 125 (buyer's payment of brokerage fees and legal and accounting expenses incurred by seller in connection with the sale treated as a payment by buyer to seller in year of sale).

⁷¹ Treas. Reg. § 1.453-12(a), (d) Ex. 3.

⁷² I.R.C. § 453(1)(1)(B).

⁷³ I.R.C. § 453(1)(2).

(1) documented, (2) supported by substantial non-tax business purposes, and (3) otherwise in accordance with the general rules for purchase price allocations (i.e., the residual allocation method applicable under Sections 1060 and 338).⁷⁴ For example, in a sale of all the assets of an on-going business in which buyer will pay a portion of the purchase price in the form of an installment obligation, the parties might agree that the transferred unrealized receivables, inventory, and other property not eligible for installment method reporting will be sold to buyer solely for cash, and that the buyer's installment obligation would be allocated exclusively to real property and other assets eligible for installment method reporting (e.g., goodwill).

It is unclear whether and under what circumstances the IRS will acquiesce to taxpayer initiated allocations of specific types of consideration to specific types of transferred assets in business acquisition transactions. The IRS initially took the position in proposed regulations relating to partnership transactions that each form of consideration must be proportionately allocated among all transferred assets.⁷⁵ In response to comments questioning the validity of this requirement,⁷⁶ the requirement was withdrawn from the final regulations and the final regulations are silent on the issue.⁷⁷

In other contexts, where there is no specific allocation in the transaction documents, the IRS has held that a pro-rata allocation is required.⁷⁸ More recently, in the context of a technical advice memorandum involving a deemed sale and contribution of assets to a partnership, the IRS appeared to

⁷⁴ Rev. Rul. 68-13, 1968-1 C.B. 195 (special allocation of down payment to inventory allowed in the context of an installment sale). *See also* Gregory J. Marich and Barksdale Hortenstine, *A Comprehensive Guide To Interpreting And Living With The Rules Governing Disguised Sales Of Property*, 110 Tax Notes 1421 (Mar. 27, 2006) (authorities cited at n.115); Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* ¶ 302.2.5 (Jan. 2006). *But see* Rev. Rul. 68-55, 1968-1 C.B. 140 (where several assets were transferred to a corporation, each asset must be considered transferred separately in exchange for a portion of each category of consideration received based on relative fair market values of the transferred assets and the consideration). In the absence of a special allocation, each element of the purchase consideration is allocated to each property based on its relative fair market value. *See* Rev. Rul. 76-110, 1976-1 C.B. 126.

⁷⁵ *See* Preamble to Prop. Treas. Reg. § 1.707-3(e), 56 Fed. Reg. 19055 (Apr. 25, 1991) (“special rules apply to prevent a partner from selectively selling certain property (e.g., property with a high basis) and contributing other property to the partnership. The partner is required to allocate the amount realized from the disguised sale among all the properties transferred as part of a planned transaction, based on the relative fair market values of each property (reduced by any qualified liability with respect to that property).”)

⁷⁶ *See* New York State Bar Association Tax Section, Report On Proposed Section 707 Regulations Concerning Disguised Sales Of Property Through Partnerships; 91 TNT 226-40 (Nov. 4, 1991) (text and authorities at n.42);

⁷⁷ *See* T.D. 8439 (Sep. 30, 1992) (“In response to comments, the rule contained in the proposed regulations requiring a partner contributing multiple properties to a partnership to allocate the amount realized among the properties based on their values has been deleted. Thus, the final regulations do not provide special rules for the allocation of amounts realized in these transactions.”).

⁷⁸ *See* Rul. 68-55, 1968-1 C.B. 140 (“In determining the amount of gain recognized under section 351(b) ... where several assets were transferred to a corporation, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. The fair market value of each category of consideration received is separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets.”).

affirmatively acknowledge that there were circumstances in which a non-proportionate allocation would be respected.

Thus, ... it appears that taxpayers have some residual ability to identify the assets that will be treated as sold, and the assets that will be treated as contributed. ... Based upon an examination of the authorities identified in the context of §§351 and 453, it appears that the ability to identify assets for divergent treatment is not unfettered. The case law appears to require both a business purpose for the different treatment, and factual indicia that the different treatment was understood and intended by the parties. ... Where there are not strong indications of different treatment, we believe that the appropriate treatment is a proportionate transfer of all underlying assets.⁷⁹

The technical advice memorandum was subsequently revoked and reissued to delete the quoted language. The reissued ruling refers to the deleted language as “incorrect” and provides no further explanation.⁸⁰ It is therefore again unclear whether and to what extent the IRS agrees that taxpayers have the ability to allocate different consideration to different assets in a single transaction.

F. Election Out of Installment Method

A taxpayer can elect out of the installment method with respect to any installment sale transaction.⁸¹ In that case, the gain from the sale is reported under the closed transaction method (discussed below), except in the “rare and extraordinary” case in which sale consideration cannot be valued at the date of sale, in which case the open transaction method is applied.

A taxpayer that elects out of the installment method is generally required to recognize gain on the sale taking into account the fair market value of all consideration received in the sale, including any fixed or contingent deferred payment obligations.⁸² This is generally advantageous only where the seller wants to accelerate income (e.g., to absorb expiring losses), or wants to avoid the interest charge on large installment sales.

For this purpose, the fair market value of a non-contingent fixed payment obligation is generally its imputed principal amount under the imputed interest rules.⁸³ In the case of contingent payment obligations issued for non-publicly traded property, the contingent payment obligation is taken into the seller’s amount realized based on the estimated fair market value of the obligation. Seller is treated as having a basis in the contingent payment obligation equal to its fair market value. As the contingent

⁷⁹ Tech. Adv. Mem. 200512020 (Mar. 25, 2005) [citations omitted]. The ruling treated the transfer in issue as a transfer of a proportionate interest in certain notes.

⁸⁰ Tech. Adv. Mem. 200650117 (Dec. 15, 2006).

⁸¹ I.R.C. § 453(d). An election out of the installment method is generally made by reporting an amount realized equal to the entire selling price on the tax return filed for the year of sale. For additional procedures on making and revoking an election out of the installment method, see Treas. Reg. § 15a.453-1(d)(3), (4).

⁸² Treas. Reg. § 1.1001-1(g).

⁸³ Treas. Reg. § 1.1001-1(g)(1).

payments are received, a portion of each payment is characterized as interest under the imputed interest rules.⁸⁴ To the extent the portion of the payment received on the obligation is characterized as principal and is greater or less than Seller's basis in the obligation, Seller will recognize gain or loss from the deemed sale or exchange of the obligation.⁸⁵ Thus, the character of the "collection gain or loss" could conceivably be long-term capital gain or loss even where the gain from the underlying installment sale might be short-term capital gain, unrecaptured section 1250 gain, or ordinary income.⁸⁶

G. Open Transaction Method

If a transaction involves one of the "rare and extraordinary cases" in which the sale of property is for a contingent payment obligation the fair market value of which cannot reasonably be ascertained (either directly or by reference to the value of the property sold), the taxpayer can report income from the transaction under the "open transaction method." Under this method, all payments received under the sale contract are reported first as a recovery of tax basis to the extent of the tax basis of the property sold for the contingent payment obligation, and then as gain from the disposition of the property.⁸⁷ The payments are not subject to the basis allocation rules, the interest charge on large sales rules, or the anti-pledging rules applicable to installment obligations, but the rules treating a portion of each payment as imputed interest (discussed above) are applicable.

Transactions reported under the open transaction method will be closely scrutinized to determine whether a true sale has taken place.⁸⁸ If it is determined that a taxpayer improperly reported gain under the open transaction method, it appears that the taxpayer would be required to report the gain under the

⁸⁴ Treas. Reg. § 1.1275-4(c)(4); Treas. Reg. § 1.483-4 (incorporating the rules in Treas. Reg. § 1.1275-4(c) for purposes of contractual deferred payment obligations not otherwise subject to those rules).

⁸⁵ Treas. Reg. § 1.1275-4(c)(5)(iii).

⁸⁶ This rule differs from the rule under the open transaction method or the installment method, which characterizes any such "collection gain or loss" as attributable to the property sold for the obligation, rather than attributable to the obligation itself. However, the character of the gain will often be the same in either case.

⁸⁷ Treas. Reg. § 15a.453-1(d)(2)(iii) ("The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale). Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation ... cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'"); Treas. Reg. § 1.1001-1(a), (g)(2)(ii) (rule requiring inclusion of imputed principal amount of contingent debt in income does not apply where the fair market value of the contingent payments is not reasonably ascertainable); *Burnet v. Logan*, 283 U.S. 404, 413 (1931) (payments based on production from mine); *Westover v. Smith*, 173 F.2d 90 (9th Cir. 1949) (payments contingent on sales of equipment manufactured by buyer under patents acquired in purchase of seller's business); *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972) (payments contingent on future production from oil and gas leases); *Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (payments contingent on outcome of pending tax controversy).

⁸⁸ Treas. Reg. § 15a.453-1(d)(2)(iii).

installment method (because the taxpayer would not have properly elected out of the installment method by reporting the entire gain from the transaction in the year of sale).⁸⁹

H. Overlap with Like-Kind Exchange Rules

1. In General

Suppose that in year 1 seller enters into a sale of real property in a Section 1031 deferred like-kind exchange transaction with a qualified intermediary (QI), and in year 2 QI acquires replacement property and transfers the replacement property and boot (if any) to seller. This transaction is literally an installment sale because the payments under seller's transaction with QI are received in the taxable year after the year of sale. However, under the normal installment sale rules, seller would likely be required to report the entire gain from the transaction in year 1 because QI's payment obligation to deliver replacement property is probably secured in year 1 by the cash proceeds from the sale of the relinquished property.⁹⁰ This is a problem because it would have the effect of overriding Section 1031. To avoid this result, Congress and the IRS have provided rules to deal with the overlap of the installment sale rules and the like-kind exchange rules. In particular, payments under an installment sale are defined to exclude obligations secured by cash or cash equivalents held in a qualified escrow account or qualified trust (as those terms are defined in the Section 1031 regulations).⁹¹

The overlap rules also provide guidance for reporting gain in like-kind exchange transactions involving boot received in the year after the transfer of the relinquished property. In the case of an exchange in which the seller receives like-kind property permitted to be received without recognition of gain under Section 1031 ("qualifying property") as well as non-qualifying property (i.e., "boot"), the rules for reporting the transaction under the installment method are modified as follows:

- the total contract price is reduced by the amount of qualifying property received in the exchange;
- the gross profit (selling price – basis) is reduced by the amount of gain not recognized by virtue of Section 1031; and
- payments received under the contract do not include qualifying property received in the exchange.

The net result is that any gain recognized on the exchange is recognized in the year in which the boot is received.

⁸⁹ See *Bolton v. Commissioner*, 92 T.C. 303 (1989). Cf. Tech. Adv. Mem. 88320002 (Apr. 29, 1988) (taxpayer that underreported gain from an installment sale in the year of sale is treated as electing out of installment method).

⁹⁰ Treas. Reg. § 15a.453-1(b)(3)(i) (payment includes obligations secured directly or indirectly by cash or a cash equivalent).

⁹¹ Treas. Reg. § 1.1031(k)-1(j)(2)(i).

Example: On 9/22/08, S enters into a contract to sell blackacre to B for \$1,000. S's basis in blackacre is \$600. S immediately assigns the contract to a qualified intermediary (QI) and has a bona fide intent to enter into a like-kind exchange transaction. QI closes the sale of blackacre to B on 10/30/08. Prior to 11/6/08 (45 days after the transfer of blackacre), S identifies whiteacre as replacement property, and on 1/11/09 enters into a contract to purchase whiteacre from C for \$800. S immediately assigns the purchase contract with C to QI. On 3/11/09, QI closes the purchase of whiteacre from C and transfers whiteacre plus \$200 to S.

The transaction is treated as if S had transferred blackacre to QI in exchange for whiteacre plus \$200. Under Section 1031, S's \$400 gain on the exchange is recognized to the extent of the \$200 cash received in the exchange.⁹² The transaction is an installment sale because S receives one or more payments under his contract with QI in 2009.⁹³ S computes the gain recognized on each payment under the installment method as follows:

- No gain is recognized on receipt of whiteacre. S's basis in whiteacre is \$600 (\$600 basis for blackacre - \$200 cash received + \$200 gain recognized).⁹⁴
- The total contract price is \$200 (\$1,000 contract price - \$800 qualifying property).
- The gross profit ratio is 100% (\$1,000 selling price - \$600 basis - \$200 gain not recognized under Section 1031) ÷ \$200 contract price).
- \$200 payment received in 2009 x 100% gross profit ratio = \$200 gain recognized in 2009.⁹⁵

If S fails to identify or purchase relinquished property within the required period under Section 1031, S's gain on the disposition of blackacre is taxable in the year the sale proceeds are distributable by QI to S.⁹⁶

If blackacre is subject to qualified indebtedness or if QI incurs or assumes qualifying indebtedness in the exchange, the debt is treated as boot. However, it is offset by any debt to which whiteacre is subject or incurred or assumed by seller in the exchange.⁹⁷

2. *Receipt of Installment Obligations*

What if the boot in a deferred exchange with a QI consists of an installment obligation issued by the buyer of the relinquished property from QI? Normally, the buyer's installment obligation would not be eligible for deferral because deferral is available only with respect to obligations of the person

⁹² I.R.C. § 1031(b).

⁹³ As noted above, the fact that QI's obligation to deliver replacement property under the exchange contract is secured by the cash proceeds from the sale of blackacre.

⁹⁴ I.R.C. § 1031(b), (d); Treas. Reg. § 1031(k)-1(j)(3) Ex. 1.

⁹⁵ Cf. Treas. Reg. § 1.1031(k)-1(j)(2)(vi) Ex. 2.

⁹⁶ *Id.* Ex. 3, 5, 6.

⁹⁷ Treas. Reg. § 1.1031(b)-1(c).

acquiring the property from the seller (i.e., QI).⁹⁸ However, this rule is called off in the case of like-kind exchanges involving qualified intermediaries. An installment obligation of the QI's transferee (buyer) is treated for purposes of the installment sale rules as an obligation of the person acquiring the property from the seller.⁹⁹

Example: Assume the same facts as in the example above, except the sale of blackacre to B is for \$800 cash plus B's \$200 unsecured note, payable in ten equal annual installments with interest at the prime rate. B's note is not payable on demand or readily tradable. QI distributes whiteacre and B's installment note to S.

S's receipt of B's installment note is not treated as receipt of a payment. S reports gain on each payment received under B's installment note based on a 100% gross profit ratio.¹⁰⁰

III. ALTERNATIVE TAX DEFERRAL OPTIONS

A. Structured Sale

1. In General

In a structured sale, a buyer of property in an installment sale assigns his installment obligation to a third party ("assignee"), typically an offshore affiliate of an insurance company, under a pre-arranged agreement entered into in connection with the installment sale. Under the arrangement, the assignee will typically purchase an annuity from its affiliated insurance company, and the seller is named as the sole beneficiary on the annuity contract. Significantly, the buyer is not released from liability under the installment obligation. However, the arrangement may provide that the insurance company will make the annuity payments directly to the seller and be credited against the buyer's installment obligation. If the annuity payments are structured to be equal in amount and timing to the payments due under the installment obligation, the buyer has no continuing obligation after the assignment so long as the insurance company makes the annuity payments.¹⁰¹

A structured sale can be used where the buyer is otherwise not interested in entering into an installment purchase. Instead of making a cash payment to the seller for 100% of the purchase price at closing, the buyer simply sends a portion of the purchase price to the assignee as consideration for the assignee's obligation to make payments to the seller. Although the buyer is legally obligated to make the payments if the insurance company defaults, the buyer generally will consider this a sufficiently remote risk that it can safely be disregarded.

⁹⁸ Treas. Reg. § 15a.453-1(b)(3)(i) (payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer).

⁹⁹ *Id.*; Treas. Reg. § 1.1031(b)-2(b), 1.1031(k)-1(j)(2)(iii).

¹⁰⁰ Treas. Reg. § 1.1031(k)-1(j)(2)(vi) Ex. 4.

¹⁰¹ Structured settlement transactions are widely advertised on the internet. *See, e.g.,* www.structuredsalespro.com.

There is no specific authority whether a structured sale will achieve its intended result: deferral of the payments due under the buyer's installment note until the payments are received. A structured sale is arguably not at odds with purposes of the installment sales rules, which allow various credit support arrangements with respect to the buyer's deferred payment obligation.¹⁰² However, there is some risk that the IRS will treat the buyer as, in substance, having transferred property (the annuity contract) to the seller at the time of the sale rather than an installment obligation, or that IRS will assert that the seller has made a taxable disposition of the installment obligation by virtue of the assignment arrangement.¹⁰³ Until specific guidance is issued, sellers should proceed with caution in the area of structured sales.

2. *Backup to Deferred Exchange*

A structured sale might be effected in the context of a like-kind exchange effected through a qualified intermediary (QI) where the sale proceeds from the relinquished property are not reinvested in replacement property. In such a case, the arrangement with the QI specifies that the QI will issue an installment note to the seller with respect to any proceeds of the relinquished property that are not reinvested in replacement property, and that the QI will assign its obligations under the installment note as discussed above. The intended effect is that to the extent the sale proceeds cannot be reinvested in replacement property, the seller can defer recognition of gain on the boot until payments are received under the annuity contract. Here again, in the absence of clear guidance from the IRS, there is significant risk that the intended tax effects will not be realized.¹⁰⁴

B. Accommodation Party Installment Sales

1. *Background – Private Annuity Transactions*

Prior to October 2006, several organizations were actively promoting installment sale transactions using a sale of property to a trust for consideration consisting of an annuity contract issued by the trust (a so-called "private annuity"), followed by a pre-arranged sale of the property by the trust to an unrelated buyer.¹⁰⁵ The intended effect was that gain on the sale of the property to the trust would

¹⁰² I.R.C. § 453(f)(3) (guarantees); Treas. Reg. § 15a.453-1(b)(3)(i) (standby letter of credit treated as a third-party guarantee). *But see* Treas. Reg. § 15a.453-1(b)(3)(i) (debt secured by cash or cash equivalents, such as a bank certificate of deposit or a Treasury note, is treated as a payment).

¹⁰³ *Cf.* Treas. Reg. § 15a.453-1(b)(3)(iii) (letter of credit given as security for payment of an installment note is treated as a payment if it may be drawn upon in the absence of a default in payment of the underlying note); Treas. Reg. § 1.453-9(g) (dispositions of installment obligations to insurance companies); I.R.C. § 1259 (constructive sale transactions). For a discussion of the applicable legal principles and risks, see R. Wood, *Breathing Life into Installment Sales*, 108 Tax Notes 201 (2005).

¹⁰⁴ For a discussion of considerations applicable in using a structured sale in the context of a deferred like-kind exchange, see R. Wood, *Structured Installment Sales as a Backup to §1031 Exchange*, 46 Tax Mgmt. Mem. 1 (2007); R. Wood, *How a Failed 1031 Exchange Can Become an Installment Sale*, 49 Tax Mgmt. Mem. 91 (2008).

¹⁰⁵ *See, e.g.*, www.napat.org (National Association for Private Annuity Trusts).

be reported only as the annuity payments were received, which in some cases commenced only some period of years after the sale proceeds were received from the buyer. The promoters relied on a 1969 IRS revenue ruling – which involved a sale of property to a trust for a private annuity, but no prearranged sale of the property by the trust – to support the claimed tax benefits.¹⁰⁶

The IRS successfully challenged several of the private annuity transactions on the grounds that the transactions lacked business purpose and economic substance.¹⁰⁷ In addition, in October 2006 the IRS took broader action to shut down abusive private annuity transactions by issuing proposed regulations under I.R.C. § 1001 that would treat receipt of an annuity contract as receipt of other property that must be included in income at its fair market value upon receipt, effectively revoking the 1969 ruling.¹⁰⁸ Significantly, the proposed regulations did not make any changes to the installment sale rules, and instead requested comments on the extent to which a sale of property for an annuity should be treated as an installment sale.¹⁰⁹ In this regard, the proposed regulations specifically provide that they do not apply to an annuity contract that is a debt instrument.¹¹⁰ To date, the IRS has not taken any action to finalize the proposed regulations or to address their interaction with the installment sale rules.¹¹¹

2. *Accommodation Party Installment Sale*

Picking up on the exception in the proposed private annuity regulations for debt instruments, the promoters of private annuity transactions are apparently now offering an alternative structure involving a sale of property to a trust or other accommodation party in exchange for an installment note (not an

¹⁰⁶ See Rev. Rul. 69-74, 1969-1 C.B. 43 (gain reported under I.R.C. § 72 rules for income from annuities). For a general discussion of treatment of private annuity sales prior to 2006, see Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 43.2.2 (WG&L 2008), discussion at footnotes 17 through 19.10.

¹⁰⁷ *Melnik v. Commissioner*, T.C. Memo 2006-25 (2006); *Stokes v. Commissioner*, T.C. Memo 1999-204 (1999). *But see Katz v. Commissioner*, T.C. Memo 2008-269 (Dec. 3, 2008) (taxpayer allowed to defer recognition of gain on exchange of stock for a private annuity and simultaneous sale of the stock by the annuity company where IRS failed to assert that the transaction was a sham or was entered into for the purpose of improperly avoiding tax).

¹⁰⁸ REG-141901-05, 71 Fed. Reg. 61,441 (Oct. 18, 2006).

¹⁰⁹ *Id.* (“The Treasury Department and IRS request comments as to the circumstances, if any, in which an exchange of property for an annuity contract should be treated as an installment sale, and as to any changes to the regulations under section 453 that might be advisable with regard to those circumstances.”).

¹¹⁰ Prop. Treas. Reg. § 1.1001-1(j)(1). I.R.C. § 1275(a)(1)(B) provides, in part, that the term “debt instrument” does not include any annuity contract to which section 72 applies and which (i) depends (in whole or in substantial part) on the life expectancy of 1 or more individuals, or (ii) is issued by an insurance company (or tax-exempt entity operating as an insurance company) and meets certain other requirements. See Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 53.3.2 (WG&L 2008).

¹¹¹ See Dept. of the Treasury, *2007-2008 Priority Guidance Plan*, p.16 (Aug. 13, 2007), available at <http://www.irs.gov/pub/irs-utl/2007-2008pgp.pdf>.

annuity), followed by a sale of the property by the accommodation party.¹¹² The proceeds from the sale of the property are invested to fund payments on the accommodation party's note, but the investments are presumably not pledged, directly or indirectly, as security for the note.¹¹³ One investment that might be suggested for the sale proceeds is an annuity contract matching the terms of the installment note and owned by the accommodation party but naming the seller as the sole beneficiary.

Whether an installment sale through an accommodation party will achieve the intended tax deferral benefits is subject to significant uncertainty. Even if the statutory related party rules can be successfully avoided, the IRS can be expected to question whether the transaction has a significant business purpose apart from tax deferral,¹¹⁴ whether the accommodation party is acting as the seller's agent, whether the accommodation party has a significant independent economic interest in the transaction, and whether the seller has constructive receipt of the proceeds of the sale to the third-party buyer held by the accommodation party.

C. Leveraged Partnership

A leveraged partnership is often promoted as a means of disposing of business assets for cash without current recognition of gain. For example, assume seller has assets that it proposes to sell to a buyer for \$1,000. Seller has a basis of only \$200 in the assets, and wants to defer recognition of the \$800 gain without deferring receipt of the cash proceeds or having to reinvest the cash in illiquid real estate assets. Seller might structure the transaction along the following lines:

Seller and buyer form a limited liability company. Seller contributes the \$1,000 of assets to the company, and buyer contributes \$600 in comparable assets. The partnership then borrows \$800 from a bank, and distributes the loan proceeds to seller. Seller's interest in the company is reduced from approximately 62.5% ($\$1,000 \div (\$1,000 + \$600)$) to approximately 25% ($\$200 \div (\$200 + \$600)$). A portion of seller's 25% equity interest might be preferred equity. Seller guarantees the bank loan. The intended tax results are: Seller recognizes no gain or loss on the formation of the company and receipt of the \$800 distribution of the bank loan proceeds.¹¹⁵ During the term of the partnership, seller is

¹¹² One active promoter of such transactions is National Association of Financial and Estate Planning, which refers to the transactions as "self-directed installment sales." See, http://www.nafep.com/sdis/self_directed_installment_sale.htm. The reference to "seller directed" in the name of the strategy hints at one of its most obvious potential problems (i.e., that the trust used to facilitate the sale will be viewed as the seller's agent). Note that the company that established the failed private annuity transaction in *Stokes v. Commissioner*, T.C. Memo 1999-204 (1999), was also named National Association of Financial and Estate Planning.

¹¹³ An installment note secured directly or indirectly by cash or a cash equivalent is treated as a payment. Treas. Reg. § 15a.453-1(b)(3)(i).

¹¹⁴ One obvious means of attack is business purpose. If the sole purpose for the private installment transaction is to avoid tax on the gain from the sale of the underlying asset, the sale to the trust might be disregarded for tax purposes. Cf. *Melnik v. Commissioner*, T.C. Memo 2006-25 (2006). There are related constructive receipt issues.

¹¹⁵ See I.R.C. §§ 721, 731, 752.

allocated and is taxed on its 25% share of the business profits, and is subject to the rules for special allocations to the contributing partner of built-in gains on contributed property.¹¹⁶ In addition, as principal payments are made on the bank debt, those payments are treated as deemed distributions to seller which first reduce seller's \$200 basis in its equity interest (increased by any allocations of taxable income, including allocations of built-in gain) and then as gain from the sale of its equity.¹¹⁷

The IRS has issued internal legal advice challenging a leveraged partnership under a variety of theories. Under the facts considered in the IRS memorandum, the IRS determined that the contributing partner's guarantee of the partnership debt could be disregarded and therefore that the transaction could be characterized as a disguised sale under Section 707(a)(2)(B), and that the transaction could be recast as a direct sale by the contributing partner to the other partner either under the partnership anti-abuse rules, substance over form principles, or by disregarding the partnership for tax purposes for lack of intent to form a bona fide partnership.¹¹⁸ Some of these arguments were based on facts unique to the situation addressed in the ruling. In other situations where there is a significant and bona fide business purpose for forming a continuing partnership (i.e., the transaction is not proposed and implemented solely for tax avoidance purposes), and the business is actually operated as a true partnership, it may be possible to sustain the intended tax consequences.

D. Unleveraged Partnership

A variation of the leveraged partnership can be used where the buyer is not going to borrow to finance the assets. In the fact pattern discussed above (seller has assets with a basis of \$200 that it proposes to sell to buyer for \$1,000), the transaction might be structured along the following lines: Seller and buyer form a limited liability company. Seller contributes the \$1,000 of assets to the company, and buyer contributes \$1,000 in cash. Seller receives an \$800 preferred equity interest and a 17% common equity interest, and buyer has the remaining 83% common equity interest. The company then loans \$1,000 to a seller affiliate. The intended tax results are: seller will recognize no gain or loss on the formation of the company and receipt of the \$1,000 partnership loan.¹¹⁹ During the term of the partnership, seller is taxed on its equity interest in the business, but the interest on the partnership loan and the guaranteed payments on the preferred equity should offset each other. To the extent principal

¹¹⁶ I.R.C. § 704(c)(1)(A).

¹¹⁷ I.R.C. §§ 731, 752. For a more thorough discussion of the intended tax consequences of such a transaction, see Michael J. Kliegman and Jerome M. Schwartzman, *Puttin' on the Blitz: The IRS Attacks a Leveraged Partnership Transaction*, 44 Tax Mgmt. Mem. No. 7 (April 7, 2003) and Robert Willens, *IRS Using Anti-Abuse Rules Where Leveraged Partnerships Technically Sound*, BNA Daily Tax Rep. No. 109, p. J-1 (June 6, 2008).

¹¹⁸ CCA 200246014 (Aug. 8, 2002). See also CCA 200250013 (Aug. 30, 2002).

¹¹⁹ I.R.C. §§ 721, Treas. Reg. § 1.61-12(c)(1).

payments on the partnership loan that are used to redeem the seller's preferred equity, the redemption payments are taxable to the extent they exceed seller's \$200 basis for its partnership interest.¹²⁰ After seven years, it may be possible to unwind the partnership and distribute the business assets to buyer and the partnership loan to seller.¹²¹

This transaction is subject to many of the same attacks that the IRS has levied against leveraged partnerships discussed above and should not be undertaken in the absence of strong non-tax business objectives and thorough legal and tax analysis.

E. Lease with Purchase Options

In many situations, a seller of real property will be interested in a like-kind exchange, but will be uncertain whether it can identify or acquire suitable replacement property within the statutorily mandated identification and exchange periods. This arises particularly in situations where the replacement property is a build-to-suit property having a completion period of more than 180 days. A similar issue can arise in a reverse like-kind exchange (replacement property to be acquired before relinquished property is sold). The seller may be concerned that it will not be able to close a sale of the relinquished property within the 180-day safe-harbor period for a reverse exchange.¹²² This section considers transactions that the seller might undertake to partially lock in the economics of the sale of the relinquished property or purchase of the replacement property prior to an actual sale or purchase for tax purposes.

If the sale of relinquished property needs to be deferred to ensure timely identification and acquisition of the replacement property, the seller could lease the relinquished property to the buyer pending identification and/or acquisition of replacement property. The lease arrangement might include an option for the buyer to purchase the property after a period of time for a fixed price approximating the estimated value of the property at that time ("call option").¹²³ In addition, the seller might also reserve an option to require the buyer to purchase the property ("put option"), exercisable only some period of time after the lapse of the buyer's call option. If the options are exercisable at different time periods and different prices, or both, or have other terms or conditions such that it is not substantially

¹²⁰ I.R.C. § 731.

¹²¹ I.R.C. § 704(c)(1)(B) (disguised sale if contributed property is distributed other than to the contributing partner within seven years of contribution); I.R.C. § 737 (gain recognition if non-contributed property is distributed to a partner who has contributed appreciated property to the partnership within seven years of the distribution).

¹²² See Rev. Proc. 2000-37, 2000-2 C.B. 308.

¹²³ See Stephen M. Breitstone, A "Safe" Approach to Non-Safe-Harbor Reverse Exchanges and Build-to-Suit Parking Arrangements, 103 J. of Tax'n 294 (Nov. 2005); Rev. Rul. 55-540, 1955-2 C.B. 39 ("a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total [lease] payments" is a factor generally indicating that a lease is a sale).

certain that one or the other options will be exercised, the options should not be viewed as giving rise to a current sale of the property.¹²⁴ Provided the other terms of the arrangement make clear that the seller retains material benefits and burdens of ownership, the seller should not be treated as having made a present sale of the relinquished property solely by virtue of entering into the lease transaction.

Deferring the sale of relinquished property can be problematic if the buyer is unwilling to enter into an acceptable lease arrangement. Deferring the purchase of replacement property may be somewhat easier to achieve if an accommodation property can be used to acquire the replacement property and then lease it to the taxpayer pending sale of the relinquished property. This is commonly referred to as a “parking” arrangement (i.e., the replacement property is “parked” with the accommodation party pending completion of the exchange).¹²⁵ To be successful, the parking arrangement must be structured so that it is clear that the accommodation party is not acting solely on behalf of the taxpayer or as the taxpayer’s agent. The precedents guiding these types of transactions prior to issuance of the safe-harbor rules in 2000 should be consulted when pursuing such a transaction.¹²⁶ Keep in mind that the more the transaction is structured to mitigate the taxpayer’s risk that the sale of the relinquished property will not occur, or to mitigate the accommodation party’s economic risk on the temporary ownership of the replacement property, the less likely it is that the intended tax consequences will be achieved.

F. Derivatives

A discussion of derivatives – contractual arrangements the value of which is determined by reference to an underlying notional asset or index – is beyond the scope of this paper. However, derivatives are commonly used to confer upon one party to the contract (the “long party”) the economic returns associated with the ownership of a specified asset without the long-party having to actually own the specified asset. Accordingly, in theory a derivative could be used to confer on a buyer the economic

¹²⁴ See *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (put and call options did not effect a present sale where the option exercise periods were staggered; there was “more than a remote possibility” that neither option would be exercised). *Accord* Tech. Adv. Mem. 8735009 (May 29, 1987), Ltr. Rul. 8609010 (undated). In *Kwiat v. Commissioner*, T.C. Memo 1992-443, the court stated in dicta that “the mere *possibility* that neither the put nor the call will be exercised should not be determinative that a sale has not occurred . . . The *existence* of the reciprocal put and call on these facts is sufficient to [indicate a sale].” (Emphasis in original.) However, other factors supported the court’s view that the transaction was a sale (e.g., the leased property was “limited use property” that could not be easily returned to lessor), and the court’s ultimate finding of fact was there was, at the time the lease was entered into, only a remote possibility that both options would go unexercised. See also Rev. Proc. 2001-28, 2001-1 C.B. 1156 (IRS will not issue a true lease ruling where the lessor has a put option).

¹²⁵ See Rev. Proc. 2000-37, 2000-2 C.B. 308, § 3.02.

¹²⁶ Section 3.02 of Rev. Proc. 2000-37 states that “no inference is intended with respect to the federal income tax treatment of “parking” transactions that do not satisfy the terms of the safe harbor.” See generally Stephen M. Breitstone, A “Safe” Approach to Non-Safe-Harbor Reverse Exchanges and Build-to-Suit Parking Arrangements, 103 J. of Tax’n 294 (Nov. 2005); Robinson, *Federal Income Taxation of Real Estate* ¶¶ 12.04[7][c], 17.02[1] (WG&L 2008).

returns associated with ownership of seller's property without seller transferring actual tax ownership of the property to the buyer.

Derivatives work well with marketable securities or widely recognized indices that have daily or more frequent published values, and where allowances can easily be made for income distributions and changes in the composition of the assets. It works less well with non-traded assets such as real property. However, derivative contracts are flexible instruments, and in some circumstances issuance of a derivative contract might be a feasible and attractive alternative to a sale of the underlying real property interest.¹²⁷

The tax consequences of derivative contracts are uncertain. For the most part, the IRS has accepted the distinction between ownership of an underlying asset and a contractual arrangement tied to the notional value of the asset.¹²⁸ Based on this principal, it has been suggested that a nonresident could use a total return swap with respect to specific real property to avoid being treated as the owner of the underlying real property.¹²⁹ However, in response to new financial instruments that purport to achieve tax results far preferable to those that could be obtained through the ownership of the underlying asset, the IRS has indicated that it is studying potential changes in tax accounting requirements for such contracts.¹³⁰

Disclaimer

Information contained in this document is not intended to provide legal, tax, or other advice as to any specific matter or factual situation, and should not be relied upon without consultation with qualified professional advisors. Any tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under applicable tax

¹²⁷ Derivative arrangements are sometimes used in lieu of traditional ownership and financing arrangements because of more favorable accounting and regulatory treatment accorded to derivative contracts.

¹²⁸ See, e.g., Rev. Rul. 2003-7, 2003-1 C.B. 363. In that ruling, the IRS concluded that a taxpayer who entered into a prepaid forward sale of stock had not effected a present sale for tax purposes. The taxpayer had the right to substitute cash or other shares for the stock pledged under the contract, and wasn't economically compelled to deliver the pledged shares. I.R.C. § 1259 (relating to constructive sales) was avoided because the number of shares to be delivered under the contract was variable based on the value of the shares at the maturity date of the contract. The constructive sale and constructive ownership rules of I.R.C. § 1259 and 1260 start from the premise that the contractual rights under a derivative contract are not equivalent to ownership of the underlying asset for tax purposes.

¹²⁹ See *Lee A. Sheppard, Derivatives Used to Beat Tax on Effectively Connected Income*, --- Tax Notes 621 (Nov. 13, 2006). The derivative would have the effect of commuting rental income (subject to withholding tax) into foreign source income exempt from withholding tax. Cf. Rev. Rul. 2008-31, 2008-26 I.R.B. 1180 (a notional principal contract tied to a broad index of United States real estate, is not a United States real property interest under Section 897).

¹³⁰ IRS Notice 2008-2, 2008-2 I.R.B. 252 (Jan. 14, 2008). One such contract that is increasingly used is an "exchange traded note." The mutual fund industry has complained that exchange traded notes, if taxed according to their form, would provide the economic returns of a mutual fund while circumventing the regulatory restrictions and adverse tax consequences (current inclusion in income of periodic income and gains) associated with mutual funds. See *No Decision on Prepaid Forward Contracts As Treasury Seeks Solution, Desmond Says*, BNA Daily Tax Rep. No. 44, p. G-7 (Mar. 6, 2008).

laws, or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matter.