

Deferring Tax With IRC 453, Without Crossing the Line (Correct)

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The installment method is the first suggestion on every tax planner's tongue, but sometimes it does not work. Andrew Gradman of the Law Office of Andrew L. Gradman discusses those situations.

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

Installment sales work like 1031 exchanges: The interest payments are taxed like rent from the replacement real property. Principal payments are taxed like partial dispositions of that property. They are more flexible than 1031s, in that the relinquished asset need not be real property. Even better, the buyer gets a cost basis, before he has paid anything. Ideally, the income from the note is more reliable than the income from the seller's old business. If the buyer's creditworthiness is in doubt, the parties can pay an assignment company to guarantee the note.

The installment method is rightly the first suggestion on every tax planner's tongue. But sometimes it does not work. This article summarizes those situations.

Prohibitions Related to Nature of Asset Sold

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

Ineligible Assets and How to Treat the Sale of Interest

Assets Not Eligible for Installment Method Do We Look Through a Partnership?

Inventory (IRC Section 453(b)(2)(B)).	Probably yes. See Rev. Rul. 89-108, which denies installment treatment to "substantially appreciated" inventory in IRC Section 751(a). Subsequently, Section 751(a) was amended to include all inventory.
Depreciable property, to the extent of depreciation recapture. See IRC Section 453(i). This is generally limited to personal property. See IRC Section 1245. Compare IRC Section 751(c)(2), other forms of recapture, and IRC Section 1(h)(6), "unrecaptured section 1250 gain" for real property.	Yes. See IRC Section 453(i).
Depreciable property, if buyer and seller are related. See IRC Section 453(g).	For an example where the IRS declined to apply look-through treatment to a partnership, see PLR 8052086.
Debt-encumbered property, to extent the resulting relief of debt exceeds the basis of the property. See Treas. Reg. Section 15a.453-1(b)(3)(i).	Yes: Debt relief is not affected by holding the debt through a partnership.
Other installment obligations. See IRC Section 453B; Rev. Rul. 60-352.	Probably yes. See <i>Mingo v. Commissioner</i> (5th Cir. 2014) 773 F.3d 629, looking through to unrealized receivables.
Personal property under a revolving credit plan. See IRC Section 453(k)(1).	Yes, in light of the discussion for inventory and installment obligations above.
Publicly traded stock. See IRC Section 453(k)(2).	No direct authority. For an argument that, by specifically providing for look-through in certain cases, Congress rejected it for all other cases, see Elliott Manning and Amanda Wilson, "Partnerships—Disposition of Partnership Interests or Partnership Business; Partnership Termination" 718-3rd Tax Mgmt. (BNA) at II.A.2.8.

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Congress has instructed Treasury to prescribe regulations providing that, in an installment sale, the sale of a partnership interest “will be treated as a sale of the proportionate share of the assets of the partnership.” See IRC Section 453A(e). Treasury has not yet done so, and it’s unclear what force the statute has in their absence. See Phillip Gall, “Phantom Tax Regulations: The Curse of Spurned Delegations” (analyzing when delegations to create regulations have independent legal force); Field Service Advice, 1995 FSA Lexis 124 (Sept. 11, 1995) (citing IRC Section 453A(e)(2) and Rev. Rul. 89-108 as authority to treat sale of partnership interest as sale of proportionate shares of partnership assets).

Prohibitions Not Related to Nature of Asset Sold

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

Sales by dealers—see IRC Sections 453(b)(2)(A), 453(l); Installment obligations secured by cash or cash equivalents—see Treas. Reg. § 15a.453-1(b)(3)(i). See Bittker & Lokken, “Federal Taxation of Income, Estates and Gifts” ¶108.3, “cash equivalent” likely does not include widely traded stocks; however, “prudence counsels against securing an installment obligation with a pledge of any debt instrument for which a market exists”; Installment obligations offered as security for another loan—see IRC Section 453A(d); Installment obligations which are payable on demand or readily tradeable—see IRC Section 453(f)(4); Sales in a particular year, if the seller holds installment obligations arising during that year of more than \$5 million. Installment treatment is not denied, but the taxpayer owes interest on the excess. See IRC Section 453A(c); Sales to a related party, who resells the asset without having borne the risk of loss in value for at least two years—see IRC Section 453(e); and Election out—see IRC Section 453(d).

Substance (Equity) Over Form (Debt)

Continuing the 1031 analogy, an installment seller may only “exchange” into the buyer’s note. That is, the seller’s new activity must consist solely of earning interest on a principal amount equal to the pre-tax sales price of her old business. Effectively, the seller must shift from an equity to a debt position. But what if the seller is not interested in becoming a lender? Using an installment note, can the seller exchange into a non-lending, equity-like position?

In my opinion, this is what intermediary installment sales seek to offer. These are marketed transactions which involve an intermediary who is formally independent but who, practically speaking, is a paid agent of seller. The intermediary purports to buy the asset from the seller for an installment note, receiving a cost basis. Then he immediately sells the asset, tax-free, to a prearranged buyer for the same price in cash, which is used to service the installment note. The most aggressive arrangements include these features:

Intermediary selects a NewCo to invest in, which reflects the seller's taste for risk and reward. Intermediary's "note" has an above-market interest rate, corresponding to the returns from NewCo, effectively shifting value of intermediary's equity to the seller. This increases the likelihood that the intermediary will default on the loan. Nevertheless, the loan is inadequately secured; it is secured by the invested assets but is not guaranteed. These transactions are popular. However, looking at substance over form, the debt seems to me to cross the line into a retained interest—that is, a high-risk, high-return, equity-like interest in NewCo.

This is not an installment sale; it is a service relationship, in which the "seller" pays for the intermediary's services of acting as the seller's sales agent and preparing documents which hide this fact. See *Cf. Knetsch v. United States*, 364 U.S. 361—the \$91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of \$233,297.68; see Treas. Reg. Section 15a.453-1(c)(1): (denying installment treatment where the seller has a "retained interest" in the property sold—that is, where "the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions").

In CCA 202118016, IRS Chief Counsel announced it was studying a particular arrangement, the "monetized installment sale." In my view, its logic applies to all intermediary installment sales. Proceed with caution.

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Author Information

Andrew Gradman is the principal at the Law Office of Andrew L. Gradman.

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