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DISPOSITION OF INSTALLMENT OBLIGATIONS

— by Neil E. Harl*

With relatively heavy use of the installment contract or contract for deed in transferring farmland,¹ the transfer or other disposition of the contract poses substantial problems for contract sellers.²

The privilege of income deferral by installment reporting is generally personal to the seller and, with one major exception,³ does not outlast the period during which the obligation is held.

**Gain on disposition.** In general, sale, gift or other disposition or satisfaction of an installment obligation results in recognized gain to the seller.⁴ The amount of the gain or loss is the difference between the basis of the installment obligation at the time of the disposition and either the amount realized in a sale or the fair market value of the obligation at the time it is disposed of other than by sale.⁵ The rules for determining gain on disposition of an installment obligation are different depending upon how the disposition occurs.

- If the installment obligation is satisfied at other than face value or it is sold or exchanged, the amount to be included in income is the difference between the amount realized and the income tax basis of the obligation.⁶ With this type of disposition, consideration is received.
- In the event the disposition takes the form of a "distribution, transmission, or disposition otherwise than by sale or exchange," the amount included in income is the difference between the *fair market value* of the obligation and its income tax basis.⁷

**Pledging installment obligations.** For many years, the I.R.S. view has been that pledging or assigning installment obligations as security for a loan, substantially equal to the amount of the obligation, constituted a taxable disposition.⁸ Some courts agreed⁹ but the result was otherwise if the interest rates and maturity dates differed and the ownership rights in the obligation.¹⁰

Effective for dispositions after December 17, 1987, in taxable years ending after that date, if any indebtedness is secured by an installment obligation involving property used in the taxpayer's trade or business or held for the production of rental income with a sales price exceeding $150,000 (except for personal use property and farm property), the net proceeds of the secured indebtedness are treated as payment received on the installment obligation as of the later of the time the debt becomes secured or the time when the proceeds of the debt are received by the seller.¹¹ The gain recognized cannot exceed the total gain from the installment obligation.¹² The refinancing of indebtedness outstanding on December 17, 1987, secured by a non-dealer real property installment obligation is treated as a continuation of the indebtedness and does not result in a deemed payment if — (1) the taxpayer is required by the creditor to refinance the loan and (2) the refinancing is provided by a person other than the creditor or a person related to the creditor.¹³ It is not clear what the consequences would be of pledging partnership interests or S corporation stock where the entity owned an installment obligation; the statute does require that the indebtedness be "directly secured,"¹⁴ indicating that such a pledge might not trigger gain.

**Death of the seller.** In the event of death of the seller within the term of an installment sale transaction, income tax on the deferred gain is not immediately due but the installment obligation as an asset of the estate does not receive a new or adjusted basis.¹⁵ Payments received after death are treated as income in respect of decedent and the recipient, whether estate representative, legatee or other successor, reports the income from the obligation in the same manner as the decedent would have done if living.¹⁶

The fair market value of the obligation is included in the decedent's gross estate.¹⁷ The value of the installment obligation may not be reduced by the estimated amount of income tax payable on installments remaining to be paid.¹⁸ However, a deduction is permitted each recipient of income in respect of decedent equal to the federal estate tax attributable to the value of the obligation.¹⁹

Except for distributions to the obligor, a decedent's estate is not charged with income inclusion as a result of distribution of the obligation to a beneficiary.²⁰ The basis in the hands of a beneficiary is the decedent's basis, adjusted for installments received by the estate prior to distribution.

Disposition of an installment obligation to the obligor is treated as a taxable disposition.²¹ Any realized gain from an installment sale is recognized by a deceased seller's estate if the obligation is transferred by bequest or inheritance to the obligor or is cancelled by the executor or administrator of the estate. The disposition is considered to occur at the earliest of the executor's assent to distribution of the installment obligation to the buyer, the cancellation of the obligation by the executor, the time the obligation becomes

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An important point to remember is that a decedent's estate is not charged with income inclusion (except for distributions to the obligor) from installment obligations; however, a disposition of installment obligations entered into by the estate constitutes a taxable disposition. This point is especially important for installment sales by the estate of special use value land to a qualified heir.

However, that section does not appear to shield from recognition the gain on distribution of an installment obligation from the estate.

Cancellation or forgiveness of an installment obligation is treated as a disposition of the obligation by the holder. Thus, if the seller forgives or cancels the obligation to pay amounts due, the result is a disposition of the obligation. If the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not less than the face amount of the installment obligation. If the parties are unrelated, the calculation of gain on disposition are to use the fair market value of the obligation. IRS has ruled, however, that cancellation of principal in a debt restructuring with a financially troubled buyer did not result in income tax consequences to the seller. That ruling, however, is questionable in light of the fact that it ignores the 1980 statutory enactment requiring recognition on cancellation or forgiveness of principal with an installment obligation.

FOOTNOTES

2 Id. at § 48.03[8].
3 See notes 15-20 infra and accompanying text.
4 I.R.C. § 453B(a).
5 Id.
13 I.R.C. § 453A(d).
17 I.R.C. § 2031.
19 I.R.C. § 691(c).
20 I.R.C. § 453B(c).
25 I.R.C. § 453B(c).
26 See Rev. Rul. 55-159, 1955-1 C.B. 391 (distribution of installment obligation from trust to beneficiary was taxable disposition). See also Ltr. Rul. 8317050, Jan. 25, 1983 (same).
28 I.R.C. § 1040(a).
29 I.R.C. § 453B(f).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

TACKING POSSESSION. The case involved the ownership of land which was fenced too far on to the plaintiff's property and was used by the defendants and their parents for just over 30 years to raise animals and crops.

The defendants claimed ownership of the disputed strip of land through acquisitive prescription (adverse possession) including the use of the land by the defendants' parents. The plaintiff argued that a survey of the land interrupted the defendants' possession of the disputed land, making