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FORGIVING PRINCIPAL ON INSTALLMENT OBLIGATIONS

— by Neil E. Harl*

For various reasons, sellers of property under installment obligations have forgiven principal occasionally in favor of the buyer. In the 1980s, much of the forgiveness of principal was to help financially troubled buyers. In other eras, forgiveness has often been motivated by a desire to pass wealth to the buyer. Developments over the past two decades have affected substantially how the forgiveness of principal is handled.

Pre-1980 situation

Before enactment of the Installment Sales Revision Act of 1980, a substantial body of case law and a key ruling had been issued on the matter of forgiveness of principal. In Minnie E. Deal, non-interest bearing demand notes were executed by daughters to their mother in “payment” for remainder interests in land which had been transferred by their mother in trust. The entire balance on the notes was canceled by the mother over a four year period. The Tax Court recharacterized the transfer as a gift, rather than a sale, on the grounds that the existence of a fixed and definite plan with donative intent to forgive payments resulted in the value of the periodic gifts being considered a present gift at the time of the transfer. Because the transfers sought to be excluded for federal gift tax purposes under the federal gift tax annual exclusion were gifts of future interests, the annual exclusion was not available.

A 1964 Tax Court case reached a different conclusion where use was made of enforceable vendor’s lien notes. Each of the vendor’s lien notes was secured by a deed of trust or mortgage on the properties transferred. The Tax Court did not recharacterize the transfer as a gift, as in Deal, but rather upheld the transaction as a sale with only the periodic forgiveness of payments under the obligation treated as gifts. A 1974 case, involving the transfer of a remainder interest in property, likewise rejected the Deal approach. The transfer in that case involved non-interest bearing vendor’s lien notes. None of the notes was actually paid by the grantees. All of the notes were forgiven.

In 1977, IRS issued Rev. Rul. 77-299 which involved transfer of real property to grandchildren in exchange for several non-interest bearing notes secured by a mortgage, each note in the amount of $3,000. The transaction was held to be a taxable gift as of the date of the initial transaction rather than a sale. Because the transferor intended to forgive the payments annually as part of a prearranged plan, the forgiveness was not considered to be a gift of a present interest. Thus, the 1977 ruling effectively embraced the Deal case. The court pointedly rejected the Haygood and Kelley cases.

Installment Sales Revision Act

Under the Installment Sales Revision Act of 1980, cancellation or forgiveness of an installment obligation is treated as a disposition of the obligation. A disposition or satisfaction of an installment obligation results in recognized gain to the taxpayer. 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. With this type of disposition, consideration is received.

If 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 obligation and its income tax basis.

For self-canceling installment notes, cancellation of the remaining installments at death produces taxable gain. The gain is apparently reported on the estate’s first income tax return. Cancellation by will of indebtedness remaining under an installment sale obligation has been held to produce gain includible in the gross income of the estate but with no income reportable by the obligor.

At death, installment obligations are treated as income in respect of decedent and the obligation does not receive a new or adjusted basis. However, disposition of an installment obligation at death to the obligor is treated as a taxable disposition. The disposition is considered to occur at the earliest of the executor’s assent to distribution of the installment obligation to the obligor, the cancellation of the obligation by the executor, the time the obligation becomes unenforceable or the termination of the administration of the estate for federal estate tax purposes. If the cancellation occurs at the death of the holder of the obligation, the cancellation is treated as a transfer by the estate of the decedent. However, if the obligation were held

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by a person other than the decedent, such as a trust, the cancellation is treated as a transfer by that person immediately after the decedent’s death.32

Forgiveness to help financially troubled buyer

IRS ruled, in 1987, that cancellation of principal in a debt restructuring involving an installment sale contract did not result in income tax consequences to the seller.33 That ruling did not recognize the enactment of I.R.C. § 453B in 1980 (requiring recognition of gain on forgiveness of principal) and has been criticized.34

FOOTNOTES
5 Id. See I.R.C. § 2503.
6 See I.R.C. § 2503(b).
8 Id.
9 Supra note 4.
10 Id.
12 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

CHAIN OF TITLE. The disputed property was part of a single parcel previously owned by a person deceased at the time of trial. Prior to the decedent’s death, the disputed property was conveyed to the plaintiff with a life estate reserved by the decedent. That transfer was not recorded. At the decedent’s death the entire parcel was transferred by will to a predecessor in interest of the defendant and title was transferred through several owners before reaching the defendant. Each of these transactions was recorded. The plaintiff or the plaintiff’s lessees continuously possessed the disputed property after the death of the decedent and used the property for planting grass and grazing cattle, repaired damage caused by storms, built a fish pond on the property, paid taxes on the land for most years and visited and made other improvements to the property. The defendants argued that adverse possession was not long enough because the possession of the decedent and the lessees could not be included in the time of adverse possession. The court held that, because title was transferred to the plaintiff by the decedent, the decedent’s possession and the lessee’s possession were included in the time of adverse possession. The court also ruled that the possession of the plaintiff, the decedent and the lessee was sufficiently open and adverse to grant title to the plaintiff. Robertson v. Dombrowski, 678 So.2d 637 (Miss. 1996).

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].*

AVOIDABLE LIENS. In October 1994, the IRS filed a notice of levy on accounts receivable held by a third party and owed to the debtor. The IRS did not file a Notice of Tax Lien. The levied funds were not paid because of pending state court actions. The debtor filed for Chapter 7 in February 1995 and the trustee obtained turnover of the funds. The IRS argued that the funds secured its claim for taxes. The court held that the funds were estate property and not a secured claim because the IRS security interest was not perfected and was, therefore, avoidable by the trustee. In re HDI Partners, 202 B.R. 524 (Bankr. S.D. Fla. 1996).

CLAIMS. The IRS had filed tax liens in 1992 for assessments made in 1991 for taxes and penalties owed by the debtor for 1989 and 1990. The IRS filed a secured claim for the taxes covered by the liens, a claim for priority taxes and a claim for general unsecured taxes. The debtor’s plan proposed to reallocate some of the priority taxes to the

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.