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Disposition of Installment Obligations
— by Neil E. Harl*

Other than for dispositions of installment obligations at death¹ and certain tax-free exchanges,² the privilege of income deferral by installment reporting is generally personal to the seller.³ Because of the potential for triggering income tax liability, all transactions involving installment obligations should be approached with care including transfer to revocable inter vivos trusts.⁴

General rule

As a general rule, the sale, gift or other disposition or satisfaction of an installment obligation results in recognized gain to the taxpayer.⁵ The amount of the gain or loss is the difference between the income tax basis of the installment obligation at the time of 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.⁶ The rules for determining taxable gain on disposition of an installment obligation differ 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.⁷ With this type of disposition, consideration is received.
- If the disposition takes the form of a “distribution, transmission, or disposition other 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.⁸

Forgiving principal

A seller who agrees to a reduction in principal under an installment sale obligation, such as with a purchase price adjustment,⁹ faces potential income tax liability from cancellation of the obligation.¹⁰ Where the buyer and seller are not related, it may be possible to argue that the fair market value of the obligation declined with any fall in collateral value and so the amount of gain is reduced, also. However, where the seller and buyer are related, the value of the obligation must be taken at its face value.¹¹

In a 1987 private letter ruling, the Internal Revenue Service held that a seller forgiving

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principal to help a financially troubled buyer did not have income to report.\textsuperscript{12} That ruling did not acknowledge the 1980 enactment of the statute requiring recognition upon cancellation or forgiveness of an obligation.\textsuperscript{13}

\textbf{Pledging an installment obligation}

For many years, pledging or assigning installment obligations as security for a loan, substantially equal to the amount of the obligation, constituted a taxable disposition, at least by the IRS view.\textsuperscript{14} But the result generally was otherwise if the interest rates and maturity dates differed and the taxpayer did not part with a substantial part of the ownership rights in the obligation.\textsuperscript{15}

However, 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 or farm property), the net proceeds of the secured indebtedness are treated as a payment received on the installment obligation.\textsuperscript{16}

The refinancing of indebtedness outstanding on December 18, 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.\textsuperscript{17}

\textbf{Other types of transactions}

Disposition of an installment obligating to children in exchange for private annuity payments constitutes a taxable disposition.\textsuperscript{18} However, a tax-free exchange of an installment obligation to a corporation or partnership does not trigger taxability of installment obligations transferred.\textsuperscript{19}

Transfers of installment obligations to a revocable inter vivos trust generally do not constitute taxable dispositions.\textsuperscript{20} However, a transfer of an installment obligation to a trust which is irrevocable and taxed as a separate entity or in which income is taxed to someone other than the trust settlor, results in a disposition.\textsuperscript{21}

Keep in mind, also, that if the obligor on the obligation becomes the owner or co-owner of the obligation, such as at death of the seller, the gain on the portion of the contract so acquired must be reported on the estate's first income tax return.\textsuperscript{22} Otherwise, the installment obligation at the death of the seller produces income in respect of decedent with the payments taxable as received after death.\textsuperscript{23}

\begin{footnotes}
\item[2] See notes 18-19 \textit{infra} and accompanying text.
\item[4] See note 19 \textit{infra} and accompanying text.
\item[6] Id.
\item[18] See Treas. Reg. § 1.453-9(c)(2). See also 6 Harl, supra note 3, § 48.03[8][f].
\item[20] See Rev. Rul. 86-72, 1986-1 C.B. 253 (gain recognized and included in decedent seller’s estate when installment obligation automatically cancelled upon seller’s death).
\end{footnotes}