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Disposition of Installment Obligations by an Estate or Trust

- by Neil E. Harl

With several exceptions, the rule is clear that the privilege of income deferral by installment reporting of gain is personal to the seller and cannot be transferred to another taxpayer. Usually, that question is raised with estates (or trusts) as to installment obligations entered into before death, which involves “income in respect of decedent.” For installment obligations transferred in whole or in part at death to an obligor (or the obligor) under the installment contract or for installment obligations cancelled at death.

However, the question can also arise with a distribution of the installment obligation to the beneficiaries of an estate or trust.

The general rule

In general, the sale, gift or other disposition or satisfaction of an installment obligation results in gain or loss to the taxpayer. The gain or loss is the difference between the income tax basis of the obligation at the time of the disposition and either the amount realized in the sale or other disposition or the fair market value of the obligation at the time it is disposed of other than by sale. Thus, the rules for determining the gain or loss depends upon how the disposition occurs – (1) if the installment obligation is satisfied at other than face value, or it is sold or exchanged, the amount of the gain or loss is the difference between the amount realized and the income tax basis of the obligation; or (2) 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 fair market value of the obligation and its income tax basis.

Installment obligations entered into before death

The general rule that gain or loss is triggered on distribution of an installment obligation is specifically made inapplicable to the transfer of installment obligations at death. In the event of death of the seller within the term of an installment sale transaction, the deferred gain is not immediately recognized but the installment obligation as an asset of the estate does not receive a new or adjusted income tax basis. Payments received after death are treated as “income in respect of decedent” and the recipient, whether estate representative, legatee or other successor, reports the gain in the same manner as the decedent would have done if living.

In order for the sale of property to have ripened to the point where the decedent has the...
right to the proceeds on the date of death, two conditions must be met – (1) there must be a legally binding contract and (2) the decedent must have performed the substantive (as opposed to the ministerial) conditions of sale. In one case, where the buyer would not accept title unless clouds on the title were cured or a purchase price adjustment was made, the property was not considered income in respect of decedent.  

The fair market value of the obligation is includible in the decedent’s gross estate and valued at fair market value as of the date of death or the alternate valuation date, up to six months after death. 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. The value of the installment obligation may not be reduced by the estimated amount of income tax payable on the installments remaining to be paid.

**Distribution of obligations entered into by an estate or trust**

In accordance with the general rule that disposition of an installment obligation results in recognition of gain or loss, the distribution of an installment obligation by an inter vivos trust to the beneficiaries of the trust upon termination of the trust was held to trigger such income tax consequences in a 1955 Revenue Ruling. In a 1996 letter ruling, after reciting the statutory framework in Section 453B and the 1955 Revenue Ruling and others, the IRS proceeded to apply the general rule to a situation where an estate disposed of an installment obligation which had been entered into by the estate. The result was a Section 1231 trade or business loss which could be carried back and forward as an ordinary loss.

**Transfers of installment obligations to a trust**

The transfer of an installment obligation to a revocable inter vivos trust generally does not constitute a taxable disposition. This is in keeping with the fact that a tax-free exchange of an installment obligation results in recognition of gain or loss on installment obligations transferred. 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.

**In conclusion**

Because of the potential for incurring income tax consequences on the transfer, all conveyances of installment obligations should be approached with caution. The stakes are often high with a substantial amount of gain (or loss) involved.

**Footnotes**


4. See Estate of Frane v. Comm’r, 98 T.C. 341 (1992), aff’d and rev’d, 998 F.2d 567 (8th Cir. 1993) (cancellation of installment obligation treated as disposition; reported on estate’s first income tax return).


7. Id.


12. Treas. Reg. § 1.691(a)-5. See Trust Co. of Georgia v. Ross, 262 F. Supp. 900 (N.D. Ga. 1966), aff’d, 392 F.2d 694 (5th Cir. 1967), cert. denied, 393 U.S. 830 (1968) (sale of stock in escrow); Claborne v. United States, 648 F.2d 448 (6th Cir. 1981) (closing of land transaction after owner’s death); Hedrick v. Comm’r, 63 T.C. 395 (1974); Ltr. Rul. 9023012, March 6, 1990 (land contract cancelable if mortgage commitment not obtained within 45 days and decedent died within 45 day period; mortgage commitment not obtained but parties proceeded to closing and gain was income in respect of decedent).

13. See Ltr. Rul. 9023012, March 6, 1990). See also Estate of Peterson v. Comm’r, 74 T.C. 630 (1980), aff’d, 667 F.2d 675 (8th Cir. 1981) (sale of calves before death but calves were too light and had to be fed for several more weeks; upon delivery under the contract, calves were not income in respect of decedent).


15. I.R.C. § 2033.


17. I.R.C. § 2032.

18. I.R.C. § 691(c).


22. I.R.C. § 172(b).


24. See Treas. Reg. § 1.453-9(c)(2). See also 6 Harl, supra note 1, § 48.03[8][f].