OVERVIEW OF ISSUES RELATING TO THE MODIFICATION OF THE INSTALLMENT SALES RULES BY THE TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 29, 2000

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of the
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INTRODUCTION

The Ticket to Work and Work Incentives Improvement Act of 1999 ("Ticket to Work Act"), enacted on December 17, 1999, contains a provision that prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. A related provision modifies the installment sale pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note.

The House Committee on Ways and Means, Subcommittee on Oversight, has scheduled a public hearing on February 29, 2000, to review the effects of the partial repeal of the installment method of accounting on small business owners and to discuss possible regulatory and legislative issues raised by the repeal. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes present law and issues relating to the installment method and the changes to that method included in the Ticket to Work and Work Incentives Improvement Act of 1999.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Overview of Issues Relating to the Modification of the Installment Sales Rules by the Ticket to Work and Work Incentives Improvement Act of 1999* (JCX-15-00), February 28, 2000.

I. BACKGROUND AND PRESENT LAW

A. Methods of Accounting

The amount of any item of gross income is required to be included in the gross income of the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.[2]

Cash method

Under the cash receipts and disbursements method of accounting, an amount is includible in gross income when it is actually or constructively received.[3] An amount does not have to be received in cash in order to be includible in the gross income of a cash method taxpayer. For example, the receipt of a negotiable note requires the value of the note to be included in gross income when the note is received,[4] even if the note does not require payment in cash until some future time.[5] Similarly, the receipt of other types of property or benefits may require their value to be included in income at the time they are received without regard to when, or if, they are ultimately converted to cash.[6]

A cash method taxpayer must also include an item in gross income if it is constructively received, even if the taxpayer has not reduced it to possession. An amount is constructively received if it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw on it.[7]

Accrual method

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[2] Sec. 451(a).

[3] Treas. Regs. sec. 1.451-1(a).

[4] Scharf's Estate v. Commissioner, 316 F. 2d 625 (7th Cir. 1963), Harris v. Commissioner, (6th Cir. 1984) 745 F. 2d 378, Jones v. Commissioner, 306 F. 2d 292 (5th Cir. 1962).

[5] Adequate interest must be provided in such a note. If adequate interest in not provided, interest will be imputed and the note revalued under section 1274.

[6] Treas. Regs. sec. 1.61-2(d).

[7] Treas. Regs. sec. 1.451-2.

Under the accrual method of accounting an amount generally is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[8] There is no requirement that cash, a note, or other property be received by the taxpayer. Under the accrual method of accounting, the item is includible in gross income because the right to receive the income is fixed, not because the income has actually been received.

B. The Installment Method

In general

The installment method provides an exception to the general principles of income recognition by allowing a taxpayer to defer the inclusion in income of amounts that are to be received from the disposition of certain types of property until payment in cash or cash equivalents is received. In general, a taxpayer using the installment method recognizes gain equal to the amount of payments received during the taxable year times the ratio the profit on the disposition bears to the total contract price. For this purpose, payments do not include the receipt of evidences of indebtedness of the person acquiring the property, unless such evidences of indebtedness are payable on demand, or are issued by a corporation or governmental entity and are readily tradable.[9]

For example, in 2000, an individual taxpayer (who is not in the trade or business of selling real estate) sells non-farm real property with a basis of $100,000 for $1,000,000, realizing a gain of $900,000 and establishing a profit ratio of 90%. At closing, the taxpayer receives $200,000 in cash and an $800,000 note bearing adequate interest that is due in 2002. The taxpayer would recognize gain of $180,000 ($200,000 received times the profit ratio of 90%) in 2000 and an additional gain of $720,000 ($800,000 received on payment of the note times the profit ratio of 90%) in 2002. The interest on the note would be included in gross income by the taxpayer according to the taxpayer's normal method of accounting.

The installment method defers the recognition of income compared to both the cash and accrual methods. Compared to the cash method, the installment method permits additional deferral when payment is received in the form of a negotiable note. The deferral is more pronounced when the installment method is compared to the accrual method, since the accrual method requires income to be recognized as soon as the taxpayer has a right to the income, without regard to when payment is received. For most dispositions, the accrual method requires income to be recognized when title to the property passes, which may substantially precede the time payment is received.

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[8] Treas. Regs. sec. 1.451-1(a).

[9] Sec. 453(f).

Pledge rules

A special pledge rule[10] provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[11] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income to the same extent as would the receipt of cash. The pledge rule requires the same recognition of income whether the taxpayer receives cash from the purchaser or uses an installment obligation to secure borrowings from a third party. Actual payments received on the underlying installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. For dispositions occurring on or after December 17, 1999, an installment obligation is considered to be pledged as security for an indebtedness to the extent an arrangement allows the taxpayer to satisfy all or a portion of the indebtedness with the installment obligation.[12]

For example, in 2000, an individual taxpayer (who is not in the trade or business of selling real estate) sells non-farm real property with a basis of $100,000 for $1,000,000; realizing a gain of $900,000 and establishing a profit ratio of 90%. At closing, the taxpayer receives $200,000 in cash and an $800,000 note bearing adequate interest that is due in 2003. In 2001, the taxpayer borrows $300,000 pledging the note as collateral. In 2002, the taxpayer receives a $300,000 prepayment on the note. The remainder of the note is paid when due in 2003.

Under the installment method, the taxpayer reports gain to the extent of proceeds received. In the year of sale, the taxpayer would recognize gain of $180,000 ($200,000 received times the profit ration of 90%).

In 2001, the taxpayer is required to report an additional $270,000 of the gain ($300,000 X .9) because the pledging of the note for the $300,000 loan is treated as a payment of $300,000 on the installment obligation. Subsequent payments on the loan would not be taken into account until they exceed the amount ($300,000) that was considered paid as a result of the pledge. Thus, this taxpayer would not report any gain as a result of the $300,000 prepayment in 2002. The final payment of $500,000 on the note in 2003 would cause the remaining $450,000 of gain to be recognized.

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[10] Sec. 453A(a)(1).

[11] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

[12] Sec. 453A(d)(4).

The pledge rules do not apply to small installment sales, those where the sales price does not exceed $150,000.[13]

Limits on the use of the installment method

The installment method may not be used in connection with the sale of certain types of property. Taxpayers (other than farmers and dealers in timeshares and residential lots who elect to pay an interest charge on the taxes they defer by using the installment method) are not allowed to use the installment method for sales to customers in the ordinary course of business or for sales of property of a type that is normally held for sale to such customers. In addition, the installment method may not be used with respect to the disposition of property on a revolving credit plan or the disposition of stocks or securities that are traded on an established securities market. In the case of sales of personal property, any gain that is attributable to depreciation on personal property must be included in gross income in the year of sale.[14] The installment method may be used only to defer the portion of the gain that exceeds the accumulated depreciation. For dispositions occurring on or after December 17, 1999, the installment method may not be used if the income from the disposition would otherwise be reported under an accrual method of accounting.[15]

Limits on tax deferral benefits in large installment sales

The amount of benefit that may be obtained through the use of the installment method is limited by the imposition of an interest charge on the tax deferral attributable to the portion of the installment sales that arise during and remain outstanding at the close of the taxable year that exceeds $5 million.[16] Dispositions where the sales price does not exceed $150,000 are not taken into account for the purpose of determining whether outstanding installment sales arising during and remaining outstanding at the close of the taxable year exceed $5 million. Interest accrues at the same rate as applies to underpayments of income tax and is treated as interest expense for other Federal income tax purposes.[17]

Assuming that the underpayment rate is an accurate measure of the taxpayer's cost of funds, the interest charge should put the taxpayer in an equivalent economic position to that it

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[13] Sec. 453A(b)(1).

[14] Sec. 453(i).

[15] Sec. 453(a)(2).

[16] Sec. 453A(a)(1).

[17] Sec. 453A(c)(2). The underpayment interest rate is the statutory rate under sec. 6621(a)(2) and is equal to the Federal short-term rate plus three percentage points.

would have been in had the installment method not been available. However, this is true only to the extent the interest charge applies. Because the interest charge does not apply to the first $5 million of installment sales that arises during and remains outstanding at the close of the taxable year, a taxpayer may obtain significant tax deferral benefits without being subject to the interest charge.

For example, three cash-basis taxpayers own unimproved land worth $11 million with a basis of $1 million. The first taxpayer sells its land for cash and recognize a gain of $10 million in the year of sale. The second taxpayer sells its land for $1 million cash and a note for $10 million due in 5 years. The installment method allows the second taxpayer to limit the gain it recognizes in the year of sale to $909,090[18] and defer the tax on the remainder of its $10 million gain for 5 years. However, the second taxpayer is required to pay an interest charge on one half of its tax deferral, the portion of the installment sale that arose during and remain outstanding at the close of the taxable year in excess of $5 million.

The third taxpayer sells an undivided one-half interest in its land for $500,000 down and a $5 million note due in 5 years, and then sells its remaining interest in the land the following year on the same terms in an unrelated transaction. The third taxpayer will be able to use the installment method without being subject to the interest charge, since the amount of installment sales arising during and remaining outstanding at the close of any taxable year never exceeds $5 million.

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[18] $1,000,000 X (10/11) = $909,090.

II. CHANGES IN THE INSTALLMENT METHOD ENACTED IN THE TICKET TO WORK AND WORK INCENTIVES ACT OF 1999

A. Overview

The Ticket to Work and Work Incentives Act of 1999 ("The Ticket to Work Act") made two significant changes to prior law with respect to installment sales.

First, a provision in the Ticket to Work Act prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The provision did not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The provision also did not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(l). The provision did not change the ability of a cash method taxpayer to use the installment method where the cash method taxpayer is considered to be the seller of the property.

A second provision in the Ticket to Work Act modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property in an installment sale. If the taxpayer pledges the installment note as security for a loan, or enters into an arrangement that gives it the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor, it would be required to treat the proceeds of such loan as a payment on the installment note and recognize the appropriate amount of gain.

The modification of the pledge rule applies only to installment sales where the pledge rule of prior law applied. Accordingly, the new rule does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales were not subject to the pledge rule under prior law.

B. Effect of Prohibiting the Use of the Installment Method for Dispositions That Would Otherwise Be Reported Using an Accrual Method of Accounting

<u>Sales by accrual method taxpayers</u>

The change made by the Ticket to Work Act to prohibit the use of the installment method for dispositions that would otherwise be reported using an accrual method of accounting effectively prevents such taxpayers from using the installment method. Accrual method taxpayers are now required to report income from all sales under an accrual method, i.e., when all the events have occurred that fix the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy.

Prior to enactment of The Ticket to Work Act, an accrual basis corporation was allowed to use the installment method for the sale of any item that was not of a type held for sale to customers in the ordinary course of business or a publicly traded security. If the installment sales for the year exceeded $5 million, an interest charge might have applied to a portion of the tax deferred by using the installment method, but the method was available.

The provision was included in Tax Relief Extension Act of 1999, as reported by the Senate Finance Committee. The legislative history indicates that the Senate Finance Committee believed that the installment method is inconsistent with the use of the accrual method of accounting and that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.[19]

Sales of accrual method S corporations by cash method owners

The change made by the Ticket to Work Act to prohibit the use of the installment method for dispositions that would otherwise be reported using an accrual method of accounting is expected to affect the availability of the installment method in certain transactions involving the sale of S corporation shares. In particular, this is expected to be the case where the owners of an S corporation sell their stock and an election is made to deem the S corporation to have sold its assets in order to provide, among other benefits, a step-up in the basis of the assets of the S corporation to the purchaser.

The consequences resulting from the change made by the Ticket to Work Act depend upon whether the disposition in question is a sale by the S corporation of its assets or a sale by the shareholder of the S corporation stock. An S corporation is a corporation whose taxable income or loss is passed through and taken into account by the corporation's shareholders, rather than by the corporation itself, whether or not the income is distributed. An S corporation can have a method of accounting that is different from the methods used by its shareholders.

The change made by the Ticket to Work Act does not affect the ability of a cash method S corporation shareholder to use the installment method to sell its shares. In that case, the sale is made by a cash method taxpayer and the installment method remains available. The change made by the Ticket to Work Act does prevent an accrual method S corporation from selling its assets using the installment method, whether the S corporation is the actual seller or is deemed to have sold its assets as a result of a section 338 election.

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[19] Report 106-201, Report by the Committee on Finance to Accompany S. 1792, the Tax Relief Extension Act of 1999, at p. 38.

This potentially affects a common method of selling an S corporation to an outside buyer. Such buyers generally prefer to acquire the assets of the company and not its stock. This allows the new owners to use their cost as the basis of the assets and recover the purchase price through depreciation and amortization. This also limits the legal liabilities associated with the old company that the purchasers may be responsible for. On the other hand, most sellers prefer to sell their stock.

The Federal tax law allows a corporation to elect to be treated as having sold its assets.[20] This allows the shareholders to sell stock and the purchasers to purchase assets, maximizing the amount of basis allowed for future cost recovery. Prior to the publication of proposed regulations in 1999, it was not clear that the election could be made by an S corporation. However, prior to the effective date of the Ticket to Work Act, the IRS addressed the availability of this election and held that it did not significantly affect the ability of the shareholders to use the installment method for the sale of their S corporation stock. The effect of the election was to treat the company as having taken an installment note in exchange for its assets and then to have distributed the note to the shareholders. The installment note retained its status and did not trigger an acceleration of income in the hands of the former S corporation shareholders.[21]

As a result of the enactment of the Ticket to Work Act, the installment method is no longer available to the accrual method corporation for dispositions occurring on or after December 17, 1999. In that case, the section 338 election to treat the S corporation as having sold its assets triggers gain at the S corporation level where the installment method is no longer available. Since an S corporation is required to pass corporate level gain through to its shareholders, the benefits of the installment method are lost to the shareholders if a section 338 election is made.

Sales of accrual method sole proprietorships by cash method owners

The effect of the change made by the Ticket to Work Act to prohibit the use of the installment method for dispositions that would otherwise be reported using an accrual method of accounting on the sale of an accrual method sole proprietorship by a cash basis owner is not clear.

The IRS has traditionally taken the position that a sale of a business that is operated as a sole proprietorship is to be considered as a sale of the individual assets that make up the business.[22] Accordingly, the IRS denies the availability of the installment method with respect to the disposition of inventory or marketable securities of a sole proprietorship, and will require the

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[20] Sec. 338.

[21] Sec. 453(h), Prop. Regs. sec. 1.338(h)(10)-1.

[22] See Rev. Rul. 68-13, 1968-1 C.B. 195, Rev. Rul. 57-434, 1957-2 C.B. 300.

immediate recapture of accumulated depreciation on personalty before the installment method is applied to any remaining gain. It has been suggested that this approach requires the sale to be considered to be made by the business, and not by the owner in his or her capacity as an owner. If this is the case, it would appear that an accrual method sole proprietorship could not be sold using the installment method.

A reading of the above cited Revenue Rulings suggests that the IRS approach was developed to limit the use of the installment method with respect to the sale of inventory. It does not follow that the sale also must be considered to be made by the accrual method business rather than the cash method owner. To the extent the installment sale is not in the ordinary course of the business, as would be the case if all or a substantial portion of the assets of the business were being sold and the owner does not intend to continue in the business, it may not be appropriate to assign the sale to the accrual method business rather than the cash method owner. An interpretation that treats the cash method owner as the seller, while retaining the concept of the sale of individual assets stated in the Revenue Rulings, could allow the continued access to the installment method for sales of sole proprietorships without extending it beyond the reach of prior law and allowing it to apply to the sales of inventory and marketable securities.

Requiring the sale of the assets of an accrual method sole proprietorship to be treated as a sale by the business and not by the owner is of particular concern because the sole proprietorship form does not provide an alternative for the transfer of ownership. A sole proprietor can only transfer the assets of the business, while a partner can transfer his or her partnership interest and a shareholder can transfer his or her stock. In either of these cases, assuming the owner did not elect to treat the sale as being made by the business, a cash method owner would retain access to the installment method.

<u>Sales of accrual method partnerships by cash method partners</u>

The change made by the Ticket to Work Act to prohibit the use of the installment method for dispositions that would otherwise be reported using an accrual method of accounting is not expected to have a significant effect on the sale of an interest in an accrual method partnership by a cash method partner. Typically, such transactions involves the sale of the partnership interest to the new partner by the old partner. Alternatively, they may involve the redemption of the old partner by the partnership in connection with a contribution to the partnership by the new partner. In either case, the sale is made by the cash method partner, and access to the installment method is not affected by the change in the Ticket to Work Act.

Following the transfer of a partnership interest, a partnership may elect to adjust the basis of partnership property to reflect the purchase price of the partnership interest. This election is made by the partnership under section 754 and does not affect the tax treatment of the selling partner.

C. Effect of Modifying the Pledge Rule

The change made by the Ticket to Work Act that modifies the pledge rule provides that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note is treated in the same manner as a direct pledge of the installment note.

For example, a taxpayer disposes of property for an installment note and the disposition is properly reported using the installment method. The taxpayer normally only recognizes gain as it receives the deferred payment but, if the taxpayer pledges the installment note as security for a loan, the taxpayer is required to treat the proceeds of such loan as a payment on the installment note and to recognize the appropriate amount of gain. As a result of the change made by the Ticket to Work Act, the taxpayer also is required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer has the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect are treated in the same manner.

This modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.