Deferred Payment Sales: Change The Basis and Character Rules

By Calvin H. Johnson

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The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project is found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes,* Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

This proposal would treat cash received after the year of a deferred payment sale as ordinary income. Cash received would also be treated like boot, that is, as gain first.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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In installment sales and open transactions, tax is deferred until payments are received. This proposal would continue to defer tax until payments are received, but would change the recovery of basis and character rules. The proposal would allocate payments first as recognition of the built-in gain on the sold property; once the entire gain has been recognized, payments would be allocated to recovery of basis. Future payments on the contract prevent basis from being lost and the proposal would prevent basis from being used against cash received to the extent basis is not lost. The proposal would make tax accounting better reflect the internal rate of return or interest-like income from the transaction.

The proposal would also deny capital gains rates to payments received after the year of sale. Capital gain is a remedy for the bunching of income into a single year, and deferred-payment sales unbunch the income. Capital gain is a tool to unlock capital to go into more productive investments, and buyer notes are not sufficiently more productive to merit an effective tax rate lower than for capital gains.

The proposal would affect both installment sales and open transactions.

I. Current Law

A. Installment Sales

Under section 453, when a seller sells property for installment payments from the buyer to be paid in later years, the seller does not need to pay tax on the deferred payments until they are received. Each payment, once received, is considered partially gain on the sold property and partially an excluded recovery of basis of the sold property. The fraction of each payment that is excluded is determined according to an overall exclusion ratio that looks to the total profit as a ratio of the total contract price. If, for instance, a taxpayer sells real estate in which the taxpayer has a basis of $40x for a buyer note promising 10 installments of $10x each, there would be no tax until a $10x installment is received. The overall contract price is $100x, and the overall profit from the sale is $100x-$40x cost or $60x. Accordingly, $60x/$100x or 60 percent of the overall contract price would be profit, and under section 453(c), 60 percent of each payment would be gain. The taxpayer's $40x basis in the sold property is recovered over the course of the installments by excluding 40 percent of each payment from tax.

Gain reported as payments are received will qualify as capital gain eligible for the maximum 15 percent tax rate, provided the property sold was a capital asset held for more than a year. Interest on the sales contract, however, is taxed to the seller as it accrues and as ordinary income. Larger deferred-payment sales (generally, with payments exceeding $250,000) must state an interest rate, at least equal to the low-risk federal borrowing rate for a comparable term, or interest at that rate will be imputed.[1]

Generally accepted accounting principles, required on nontax financial reports of public companies, do not allow installment sales and require that the full gain or loss from a sale be recognized in the year of the sale of the property. Installment sales are also inconsistent with buyer treatment of the same transaction, because the buyer gets an immediate addition to depreciable basis for all the principal payments yet to come. The inconsistency between the buyer's rules for basis and the seller's

[1]Section 1274.

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deferral of tax creates a "tax float" under which installments disappear from the tax base for the years between depreciation deductions and the time the installment is actually paid.[2]

Access to the tax deferral under the installment method for tax purposes has been constricted in recent years. The installment method is not generally available for sales of inventory, for property held for sale to customers,[3] and for stock or other securities regularly traded on an established market.[4] Buyer notes payable on demand and readily tradable notes are treated as if they were an immediate payment.[5] Pledging installment notes is sometimes treated as a payment on the notes.[6] Sales to related parties are eligible for installment sales, but dispositions of the sold property by the related party sometimes trigger recognition of the deferred gain.[7] Depreciation recapture occurs immediately at the time of sale.[8] Interest, payable to the government, is charged on tax deferred if a taxpayer's installment notes exceed $5 million.[9] Installment sales still allowed are estimated to entail loss of revenue of $7.6 billion over the five-year period 2009-2013.[10]

Installment sales are available even if there are contingencies that mean the payments are not fixed. If the contract provides for a ceiling (maximum amount of payments), then the exclusion ratio of overall profit to overall contract price is calculated assuming all contingencies are resolved to yield the maximum payments.[11] If there is no maximum, but there are limits to the time of payments, then basis is amortized to yield equal deductions in each year of payment.[12] If neither maximum payments nor maximum years are fixed, then basis of the sold property may be amortized over 15 years.[13]

Installment payments are income in respect of a decedent (IRD),[14] and they do not receive the benefit of step-up in basis at death if the seller should die before all payments are received. The surviving beneficiary receiving the payments includes the gain on his return and is taxed at the beneficiary's tax rate. The payments are long-term capital gain if they were long-term capital gain to the decedent seller.

B. Open Transaction

Section 453 is the default rule, available without election, but a taxpayer may elect out of section 453 on the tax return for the year of sale. Generally, election out means that the principal of notes and the fair market value of contingent payments and other property received are treated as an amount realized and taxed immediately.[15] In "rare and unusual circumstances," however, the fair market value of property and contingent payments received in the sale cannot be "reasonably ascertained."[16]

When the value of property and contingent payments cannot be reasonably ascertained at the sale, then the seller reports payments, as received, under the open transaction doctrine.[17] Under that doctrine, the first payments are tax-free recovery of basis in the sold property. Gain is taxed only after payments exceed all the basis. Open transaction sales are more favorable to the taxpayer than installment sales because the latter makes early payments partially gain and only partially recovery of basis according to the overall exclusion ratio. Under the open transaction doctrine, gain once recognized is treated as capital gain if the property sold was a capital asset.[18]

If the seller dies before receiving all payments from an open transaction sale, payments are IRD to the estate or beneficiary who receives them.[19] As IRD, the payments are long-term capital gain if they were long-term capital gain to the deceased seller, but they are reported on the recipient's tax return, under the continuing logic of the option transaction doctrine, and are taxed at the recipient's tax rate. The section 1014 step-up in basis at death does not apply to open transaction payments.

II. Reasons for Change

A. Installment Sales

1. Recovery of Basis. A system that treated cash received in a deferred-payment sale as first a recognition of gain on the sold property would better reflect income than

[2]Calvin H. Johnson, "A New Way to Look at the Tax Shelter Problem," *Tax Notes*, May 14, 1984, p. 765.

[3]Section 453(b)(l). Sales of timeshares and residential lots may be sold on the installment method even if held for sale to customers in the ordinary course of a trade or business, but interest is imposed — at low-risk applicable federal rates — on the tax deferred between the time of sale and the time of payments. Section 453(l)(2)(B) and (l)(3).

[4]Section 453(k)(2).

[5]Section 453(f)(4).

[6]Section 453A(d).

[7]Section 453(e).

[8]Section 453(i).

[9]Section 453A. *See also* section 453(l)(3) imposing interest on timeshares and residential real estate sold by a dealer and reported under the installment method.

[10]Office of Management and Budget, *Budget of the United States Government Fiscal Year 2009, Analytical Perspectives*, at 289, Table 19-1, row 58, *available at* http://www.whitehouse.gov/omb/budget/fy2009/pdf/apers/receipts.pdf.

[11]Temp. reg. section 15.453-1(c)(2).

[12]Temp. reg. section 15.453-1(c)(3).

[13]Temp. reg. section 15.453-1(c)(4).

[14]Section 691(a)(4).

[15]Reg. section 1.1001-1(g).

[16]Reg. section 1.1001-1(g)(2)(ii).

[17]*Burnet v. Logan*, 283 U.S. 404 (1931).

[18]*See, e.g., Commissioner v. Carter*, 170 F.2d 911 (2d Cir. 1948).

[19]Receipts under the open transaction doctrine are properly IRD, because an open transaction sale is still "clearly a sale" by the decedent (*Dorsey v. Commissioner*, 49 T.C. 606, 663(1968)), and IRD includes sales proceeds "to which the decedent had a contingent claim at the time of his death." Reg. section 1.691(a)-1(b)(3). The inquiry is whether the transaction had "sufficiently matured as of decedent's death" to create in him a right to the payments that were subsequently received. *Estate of Bickmeyer v. Commissioner*, 84 T.C. 170 (1985). Contingencies not requiring added action by the decedent or recipient do not defeat IRD. *Lindeman v. Commissioner*, 213 F.2d 1, 5 (9th Cir. 1954) *cert. denied*, 348 U.S. 871 (grapes had been delivered to co-op, but co-op still had to market them).

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current law does. Basis would be treated as neither lost nor recovered to the extent of the value of payments yet to come.

a. Denial of loss for costs that have not expired. Both installment sales under section 453 and the open transaction doctrine misdescribe the taxpayer's economic situation by allowing the taxpayer to recover basis that has not been lost. An important purpose of tax accounting is to distinguish between expired or lost amounts and amounts that remain as investments because they have continuing value: Lost or expired costs are currently deducted or used for exclusions as recoveries of basis, but costs that have continuing value normally remain part of basis and are not recognized until later.[20] The taxpayer has not lost its costs to the extent that the payments yet to come give the costs continuing value beyond the end of the year.[21] Under accounting terminology, a cost with continuing value is an ''asset'' that is put on the balance sheet as a contribution to net worth, and is not an expense of the current period. The accounting term ''asset'' and the tax term ''basis'' are synonyms within different accounting systems, and costs with continuing value are in theory basis or assets rather than current expenses in both systems. It follows that if payments yet to come are worth as much or more than adjusted basis, then payments received from a deferred sale are appropriately treated as gain entirely. In accounting that reflects income, adjusted basis is maintained to be equal to the remaining value of the contract.

For example, assume again that the taxpayer sells real estate in which it has a basis of $40x for a buyer note of 10 $10x installments. Assume also the installment payments bear interest between the time of the sale and payment, at a rate negotiated at arm's length by buyer and seller. The interest means that each installment is worth its face amount or $10x.[22] Accordingly, for the first six payments, the taxpayer still has an installment contract that is worth more than $40x, and his basis, originally in the land but brought over to the contract, has not been lost. The first six payments under the contract should not be treated as a recovery of the $40x basis because the $40x investment has not been lost. Accordingly, the first six payments are entirely gain. The last four payments, however, do represent a reduction in the value of the investment, much like a withdrawal from a bank account. The $40x basis would be recovered against those last four payments and would exclude the payments from tax. A single payment can be partly gain, and partly recovery of basis as necessary to keep the adjusted basis or asset equal to the value of the payments yet to come.

b. Identifying internal rate of return.[23] A normatively attractive income tax would keep the adjusted basis of investments equal to the remaining value of the investment to identify the internal rate of return from the investment as its taxable income. Financial analysis and capital budgeting use a universal yardstick, ''internal rate of return,'' to choose among investments. Internal rate of return is the annual interest given by a hypothetical bank account that matches the investment under examination in its deposits and withdrawals. Calculation of an interest rate — that is, the internal rate of return — also identifies a balance for the hypothetical bank account on which the interest is earned. The bank account balance will equal the net present value of cash flows yet to come at a discount rate equal to the internal rate of return. A tax or accounting system that identified the internal rate of return from an investment would always leave the adjusted basis or asset balance for the investment equal to that bank account balance.

Keeping adjusted basis equal to the value of remaining payments has several strong virtues. Tax would be imposed on the internal rate of return no matter what the nature of the investment. If all investments have an adjusted basis equal to value, then investments would be made according to their pretax or nontax value. Within reasonable assumptions, investors who face different tax rates are willing to pay the same price for the investment only if the adjusted basis is equal to the present value.[24] Keeping the adjusted basis equal to value prevents debt financing from yielding artificial losses that would shelter unrelated income from tax.[25]

c. Boot in a continuing investment. Allocating installment payments first to gain and only thereafter to basis also follows from the model and rationale for taxing boot in a reorganization or like-kind exchange. Under current law, gain is not recognized on the receipt of stock in a corporate reorganization or of like-kind property in an exchange, on the ''underlying assumption . . . that the new property is substantially a continuation of the old

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[20]In inventory accounting, for example, inventory still held is an asset, and cost of inventory not found and counted is deducted as cost of goods sold.

[21]*United States v. Miss. Chem. Corp.*, 405 U.S. 298, 310 (1972) (expense that ''is of value in more than one taxable year'' is a nondeductible capital expenditure); *INDOPCO v. Commissioner*, 503 U.S. 79, 87 (1992) (benefits beyond the year are important in determining whether expenditure is capital).

[22]The assumption that interest will be enforced by negotiations between the creditor and debtor underlies the rule giving buyers full credit in the basis for debt owed to buy property. For large sales, if stated interest is not at least as high as risk-free interest rates for comparable terms, then the tax law will restate principal to find at least risk-free interest rate. Section 1274.

[23]For the argument in this section, see Paul Samuelson, ''Tax Deductibility of Economic Depreciation to Insure Invariant Valuations,'' 72 *J. Pol. Econ.* 604 (1964), which is the pioneering article. Johnson, ''Kahn Depreciation and the Minitax Baseline in Accounting for Government Costs,'' *Tax Notes*, Dec. 30, 1991, p. 1523, has an example of its application.

[24]Samuelson, *supra* note 23, treated the independence of the purchase price from the tax rate of the purchaser as a special virtue of the system.

[25]This is true because internal rate of return analysis is treating the cash flows in the same way that loan balances are computed. The core logic is that all investments will be measured as if they were debt equivalents. Johnson, ''Soft Money Investing Under the Income Tax,'' 1989 *Ill. L. Rev*. 1019, 1069-1071 (1990) and Johnson, ''Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation,'' 61 *Tex. L. Rev*. 1013 (1983), emphasize the inconsistency of debt and tax accounting that lets adjusted basis drop below the real investment value.

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investment still unliquidated."[26] If the taxpayer receives cash in the transaction, however, then the cash withdrawn is not a continuation of investment. Under the boot rules, the gain is taxed to the extent of cash received.[27] The taxpayer's basis resides in the like-kind property or stock, so the taxpayer has not lost basis and is not allowed recovery of basis until after all the built-in gain on the property given up has been taxed.

There is no reason for a deferred sale of property to produce less tax than a continuous investment eligible for special nonrecognition provisions for reorganization and like-kind exchanges. Even if we view an installment sale as a continuation of the investment in the sold property, cash withdrawn from the investment should be taxed, gain first, under the model of cash boot in a continuing investment.

d. Gain first is consistent with the installment sale rationale. The rationale for installment sales is that the deferral of tax is given to allow a taxpayer "to actually realize the profit arising out of each installment before the tax [is] paid . . . [so] the tax [can] be paid from the proceeds collected rather than be advanced by the taxpayer."[28] That rationale does not prevent the entire payment from being taxed as gain when gain first is the appropriate result.

2. Capital gain. Combining capital gains and the deferral in tax reduces the effective tax rate on a deferred payment sale to a level lower than for capital gains alone. Assume, for instance, that $100 gain would bear $15 in capital gains taxes imposed on the sale. If the $100 is reported in equal installments over the next 15 years, then the $15 tax can be paid by setting aside only $10.38 to pay the tax. The discounted present value is like having a 10.38 percent tax immediately rather than a 15 percent tax rate.[29] Deferral of tax is more valuable the longer the term of the buyer notes, so that the incentive in the tax treatment is for the seller to lock into very long-term buyer notes. The lower-than-capital-gains rates for the long-term buyer notes undermine the "unlock capital" and the "bunching" rationales that underlie the lowered rate on the capital gains.

a. Unlock capital. The primary argument for the capital gain advantage is that the lower rate is given to unlock capital held in appreciated property to allow it to move to the most profitable productive investments.[30] A long-term buyer note, however, is unlikely to be the most productive investment in the economy or to be even more meritorious than the property being sold. Long-term buyer notes are not an especially meritorious good. Sellers should be going into investments that make a bigger contribution to productivity. The lower than 15 percent rates given by the combination of deferral and capital gain undercut the anti-lock-in purposes of the capital gains rate.

b. Bunching. Capital gain is said to be necessary to prevent bunching of income that was accrued over many years.[31] Installment sales provide a self-help remedy under which taxpayers spread out their income over many years under their contract so as to prevent bunching of income. The economic benefit of deferring tax, moreover, would reduce the impact of any bunching of income that remains.

3. No installment sales as an alternative? The proposal would not prevent a seller from electing out of the revised installment sale treatment, as allowed by current law. With election, the full $60x gain would be taxed at capital gains rates in the year of sale. Principal payments thereafter would be a tax-free recovery of basis, much like withdrawal of principal from debt or a bank account. The proposal would not prevent the buyer from borrowing money from a third party and paying the seller immediately in the year of sale, and indeed, third-party debt does not have the tax float problem of inconsistency between buyer and seller that current installment sales have.[32]

The proposal is not intended to foreclose repeal of installment sales in full. Deferred recognition under the installment method is not acceptable under nontax accounting standards. Deferral on installment sales is inconsistent with the well-established treatment of the buyer's basis as if the buyer had paid the full principal. The sale is a realization event in which the buyer receives notes which, with appropriate interest, are worth their face amount or will be restated to take account of

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[26]Reg. section 1.1002-1(c). *See also* H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 (Part 2) C.B. 554, 564 (saying that in a like-kind exchange, "the taxpayer's money is tied up in the same kind of property as that in which it was originally invested"); reg. section 1.368-1(b) (saying that in a corporate reorganization, the amount is not taxed because it represents "only a readjustment of continuing interest in property under modified corporate form").

[27]Sections 356, 1031(b), and 1033(a)(2).

[28]*Prendergast v. Commissioner*, 22 B.T.A. 1259, 1262 (1931).

[29]Deferral of $100 over 15 years means that only $15/15 tax is paid every year. At a 5 percent discount rate, the present value of the tax is $15/15 * (1-(1+5%)-15)/5% = $10.38 under the standard formula for present value of an annuity.

[30]*See, e.g.,* Richard Schmalbeck, "The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best," *Tax Notes*, July 9, 1990, p. 195, 200; Walter Blum, "Rollover, An Alternative Treatment of Capital Gains," 41 *Tax L. Rev*. 383, 387-388 (1986); Joel Slemrod and Martin Feldstein, "The Lock-In Effect of the Capital Gains Tax: Some Time Series Evidence," *Tax Notes*, Aug. 7, 1978, p. 134; Richard Goode, *The Individual Income Tax*, 197-208 (rev. ed. 1976); James Wetzler, "Capital Gains and Losses," in *Comprehensive Income Taxation*, 115, 135-138 (Pechman, J. ed. 1977); Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," 15 *Nat'l Tax J*. 337 (1962); Ernest Brown, "The Lock-In Problem," in *Papers on Federal Tax Policy for Economic Growth and Stability*; Subcommittee on Tax Policy, Joint Comm. on the Economic Report, 83d Cong., 1st Sess. at 381 (1955); Joseph Dodge, "Restoring Preferential Capital Gain Treatment Under a Flat Rate Income Tax," *Tax Notes*, Sept. 4, 1989, p. 1133, 1137. *See also* Walter Blum, "A Handy Summary of the Capital Gains Arguments," 35 *Taxes*, 247, 257 (1957) (characterizing the lock-in argument as a "formidable indictment").

[31]*See, e.g., Commissioner v. Gillette Motor Transp.*, 364 U.S. 130, 134 (1960) (saying the Court has long held that capital gains rates are "to ameliorate the hardship of taxation for the entire gain in one year").

[32]*See* Johnson, *supra* note 2.

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unstated interest. The proposal here, however, is consistent with good tax theory even if deferred tax is continued for deferred payment sales.

B. Open Transaction

1. Capital gain. The arguments for denying capital gains rates on installment payments after the year of sale are equally salient for open transactions: Open transaction payments are unbunched or spread out over multiple years under the contract of sale, and deferral ameliorates whatever problems of bunching remain. Low capital gains rates are given to induce movement to the most productive investments, and movement into seller notes give back too little as a quid pro quo for tax rates that are even lower than capital gains rates. Open transactions should not benefit from *both* lower capital gains rates and tax deferral.

There are added reasons to deny capital gain for open transactions. The contingencies that lead to open transactions are usually in lieu of ordinary periodic income. They tend to be earn-outs, dependent on future earnings of a sold business or changes in the prevailing interest rates. A participation in ordinary earnings and interest should be ordinary income, even if the income was originally received in a sale of capital assets. A deferral of tax on sale, accorded because of difficulties in valuing the sale price, should not transmute what should be ordinary income from earnings or interest into capital gain.[33]

It is, accordingly, proposed that all payments received under the open transaction doctrine after the year of the sale would be ordinary income.

2. Recovery of basis. For all investments, including both open transactions and installment sales, tax accounting that identifies financial income (that is, interest or internal rate of return) is neutral and meritorious. As noted, the internal rate of return can be identified only if adjusted basis is equal to net present value of remaining payments. Applying that principle is harder in an open transaction, however, because the open transaction doctrine applies only when the property and contingent payments yet to come are hard or impossible to value.

a. Close more transactions. The best solution to bringing adjusted basis up to fair market value is to close more transactions, on the basis of best estimates. The allowance for open transactions have contracted in scope over the years. *Burnet v. Logan* seems to have decided to defer tax under a test that only cash equivalents were taxed in the year of sale or that only property with readily ascertainable value was taxed on sale.[34] The current statutory test is that the fair market value of property received in a sale is part of the amount realized even if it is extraordinarily hard to value the property.[35] Current regulations state that it will be possible to value the amount realized ''except in rare and unusual circumstances.''[36]

Ideally, a transaction should be closed even if the best that can be done is to ascertain a crude or broad-range estimate of the value of the contingent rights and property received. If estimates prove wrong, then they will be corrected by gains or losses at the end of the transaction. Closing the transaction on the basis of an estimate of fair market value of contingent payments and property received will bring the adjusted basis of the investment as close as possible to the ideal measurement of income that adjusted basis needs to reflect the bank account balance of the hypothetical bank account. Perfect determination of the present value should not be the enemy of the good or the acceptable, taxing the gain and setting the resulting basis on the basis of the best estimates that are available.

It is also possible to close the transaction on the basis of the barter equation that the sold property and the sale price must be equal by reason of the bargaining in an arm's-length sale between an adverse buyer and seller.[37] Real estate and stock have markets for comparable property that make it feasible to reach an estimate of value even when the sales contract has contingencies that make it impossible to trade the contract on an established market or to get market-price quotes on what the contract is worth.

Treating payments taxed after the first year as ordinary will give taxpayers an incentive to give up deferral of tax on an open transaction and report high current values. Only for long deferred payments is deferral more valuable than the lowered rate on capital gain.[38] With a taxpayer incentive to value the consideration received, taxpayers will be more likely to enter into contracts that can be valued, and the system can reach a value with more taxpayer help both in planning and in valuation.

b. Gain first for open transactions. Some sales contracts do fit within the ''rare and unusual'' case that neither the sold property nor the contract of sale can be feasibly valued. The rule that first payments are allocated to gain,

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[33]*See also* Jeffery L. Kwall, ''Out With the Open-Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales,'' 81 *N.C. L. Rev*. 977 (2003) (arguing that contingent payments should be taxed as ordinary income in open transaction). Kwall also argues that contingent payments should not be part of a buyer's basis, on the theory that the contingent payments represent an interest retained by the seller. The suggestion is worth consideration but need not be adopted here.

[34]*Id*. at 993; William Andrews, *Basic Federal Income Taxation* 913 (1979) (saying Revenue Act of 1918 looked to ''equivalent to cash'' and Revenue Act of 1921 looked to ''readily realizable fair market value''). *Logan* involved tax year 1916, but the statutory test near the time of the tax year indicates an intellectual climate in which it was harder to find an amount realized than under current section 1001.

[35]Section 1001(b).

[36]Reg. section 1.1001-1(g)(2)(ii).

[37]*See, e.g.*, *United States v. Davis*, 370 U.S. 65 (1962) (finding value of inchoate divorce rights by reference to the value of marketable stock given up for them).

[38]At 5 percent discount rates, a 35 percent ordinary tax deferred tax is better than a 15 percent capital gain tax imposed immediately only if the ordinary tax is deferred for over 18 years.

High value means immediate capital gain for the seller, but higher purchase price or basis for the buyer and larger depreciation deductions if the property is depreciable. Viewed jointly, the two parties are better off reporting higher basis even though they must pay capital gains tax income except as to depreciation deductions taken more than 18 years after the sale, again at 15 percent capital gain, 35 percent ordinary income tax, and 5 percent discount rate.

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because basis is maintained by the payments yet to come applies in principle to open transactions as well as to installment sales, with compromises made necessary by the difficulties of valuation.

It is proposed that contingent elements of a sales contract be treated as interest or participation in earnings, that is, as ordinary income, without recovery of basis. Fixed minimum payments for the property would be treated as principal to determine how much gain there is on the sale. Payments of principal would be gain first. The gain would be capital if the payments are received in the year of sale and ordinary if received in years after the sale. When all built-in gain on the property has been recognized, payments in the nature of principal would be a tax-free recovery of basis. If the last payment on the contract is complete, without the taxpayer recognizing all the basis of the sold property, the seller would recognize the remaining basis as a loss. The loss would be a capital loss first, to the extent of prior capital gain, and ordinary loss thereafter.

If the taxpayer can show by clear and convincing evidence that the adjusted basis has been allowed to stay too high, then the tax system can probably accommodate the extra complexity of taking the taxpayer's clear proof and allowing a loss before termination of the contract. At times it is the IRS that will need to argue that the basis is too high and that clear reflection of income requires that a loss be allowed, and the IRS should be able to establish that loss.[39]

Current temporary regulations inappropriately allow amortization of basis over 15 years when the contract has neither a maximum principal amount nor a maximum period of payments.[40] The 15-year tax life was chosen at a time in which 15 years was the tax life allowed for depreciable real estate, under conditions of high inflation. When the contract has an indefinite life, akin to land or corporate stock, the appropriate rule is no depreciation. Giving a 15-year life to an investment that does not depreciate reduces the effective tax rate to about half the statutory tax rate.[41]

[39]For example, in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *Doc 98-31128*, *98 TNT 202-7*, the partnership took a trivial recognition of basis at a time when the partnership interests were held overwhelmingly by a tax-indifferent foreign bank, leaving a very high basis in the partnership that was claimed as an artificial loss by a domestic partner. The basis needed to be dropped to fair value when the partnership changed hands to reflect the true income of the two partners. The court in the case denied the domestic partner the loss that technical law would have given it, on the grounds that tax does not allow artificial accounting losses.

[40]Temp. reg. 15.453-1(c(4) (1994).

[41]Johnson, "The Mass Asset Rule Reflects Income and Amortization Does Not," *Tax Notes*, Aug, 3, 1992, p. 629, 633 (assuming 10 percent discount rates).

Sometimes the property received in an open transaction has a character that properly determines use of basis. If stock, partnership interest, or land are received in an open transaction, the basis allocated to the stock, interest, or land should not be depreciable, because those properties are not depreciable outside the open transaction doctrine.

III. Explanation of the Proposal

A. Installment Sales

Payments received under an installment sale would be allocated first to gain from the sale. Gain from the sale would be determined by subtracting adjusted basis of the sold property from the total contract price. Payment would be tax-free recovery of basis only after all gain from the sale has been recognized.

Payments and property taxable in the year of the sale would qualify as amounts realized with respect to the sold property. Payments taxable after the year of sale would be ordinary gain.

Thus, for example, assume that a taxpayer in the highest tax bracket sells real estate, a capital asset held for more than a year, in which the taxpayer has a basis of $40x for a buyer note, bearing fair market value interest, and paying 10 equal installments of $10x. Only the first payment is received in the year of sale. The first payment would be capital gain, bearing tax at 15 percent, and the next five payments would be ordinary income, bearing tax at 35 percent. The final four payments would be a tax-free recovery of the $40x basis that was originally in the sold real estate.

Basis in the contract of sale would be adjusted downward by payments treated as recovery of capital.

B. Open Transactions

Payments and property taxable in the year of the sale would qualify as amounts realized with respect to the sold property. Payments taxable after the year of sale would be ordinary income.

Transactions would be closed on the basis of estimates of value as to amount realized, taking into account evidence related to either the contract or the property sold.

When the transaction cannot feasibly be closed in the year of sale, payments, property, and rights to payment that are taxable in the year of sale shall be allocated to gain on the sold property, to the extent of gain, determined by looking to the minimum principal under the contract of sale. Contingent payments, when made, shall be considered ordinary income without use of basis. Property received in an open transaction that is depreciated under principles outside open transaction rules may be depreciated under those rules even though received in an open transaction.

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