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Installment Method Asset Sales by S Corporations

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I. INTRODUCTION

A. *Background*

Changes in the Internal Revenue Code[1] since 1980 have significantly affected taxpayers who operate a trade or business in the form of an S corporation.[2] The Subchapter S Revision Act of 1982[3] made a sweeping overhaul of the subchapter S tax regime. The 1982 Act increased the maximum number of permissible S corporation shareholders,[4] narrowed the concept of a "second class of stock" to permit S corporations to issue nonvoting common stock[5] and to allow a straight debt safe harbor,[6] decreased the danger of inadvertent termination of S status,[7] relaxed the limitations on passive investment income,[8] allowed more losses to be offset against shareholder income,[9] and generally altered the rules governing the pass-through of income and expense items and the distribution of cash or other property so that the S regime has moved closer to the partnership paradigm.[10] As a result, S corporation status now

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1. Except as otherwise noted herein, all section references are to the Internal Revenue Code of 1986, as amended through June 30, 1990 ("I.R.C." or the "Code").

2. An "S corporation" is defined in section 1361(a) as a small business corporation which has made an effective election to be taxed as an S corporation. I.R.C. § 1361(a)(1) (1990). To be a "small business corporation" for these purposes, the corporation must meet a number of qualifications. It must not have more than 35 shareholders, all shareholders must be individuals (except for estates and certain trusts), no shareholder can be a nonresident alien, and the corporation can have only one class of stock (although differences in voting rights are disregarded for this purpose). *Id.* § 1361(b)(1). Certain corporations are ineligible to elect S status even if they meet the above requirements. *Id.* § 1361(b)(2). Ineligible corporations include members of affiliated groups, certain financial institutions and insurance companies, domestic international sales corporations (DISCs) and former DISCs, and certain corporations conducting business in Puerto Rico and the Virgin Islands. *Id.*

3. 96 Stat. 1669 (1982) (codified as amended at I.R.C. § 1361 (1990)).

4. I.R.C. § 1361(b)(1)(A) (1990).

5. *Id.* § 1361(b)(4).

6. *Id.* § 1361(b)(5).

7. *Id.* § 1362(f).

8. *Id.* § 1362(d)(3)(A)(i)(II).

9. *Id.* § 1366(d); *see* S. REP. No. 640, 97th Cong., 2d Sess. 18 (1982) (comparing old and new law).

10. I.R.C. § 1366 (1990); *see* S. REP. No. 640, 97th Cong., 2d Sess. 15-17 (1982) (illustrating new pass-through rules and noting general correspondence with partnership taxation rules). In some respects, the tax treatment of S corporations continues to differ radically from that of partnerships. For example, under the one-class-of-stock rule of section 1361(b)(1)(D), each share of stock in an S corporation must carry the same rights to share in the corporation's profits and assets. I.R.C. § 1361(b)(1)(D) (1990). In contrast, the partnership provisions allow for flexibility in allocating economic rights among partners. *Id.* § 704(a) (stating partner's distributive share generally determined under partnership agreement). A second difference is that a distribution of appreciated property by an S corporation generally causes the corporation (and, therefore, the shareholders) to recognize gain at the time of the distribution. *Id.* § 311(b). A distribution of appreciated property to a partner, however, generally is not taxable to the partnership. *Id.* § 731(b); *cf. id.* § 704(c) (providing for gain recognition by a partner contributing appreciated property if the partnership distributes that property to a different partner within five years).

comes closer to fulfilling its promise of offering the tax advantages of partnership form combined with the limited liability of corporate form. More recently, the emergence of a maximum individual income tax rate (28%)[11] that is lower than the top corporate income tax rate (34%)[12] has made pass-through entities increasingly attractive as vehicles for investment or for operation of a trade or business. Perhaps most significantly, however, after the Tax Reform Act of 1986[13] repeal of the so-called *General Utilities* doctrine,[14] a C corporation (i.e., a corporation which has not elected to be an S corporation) distributing appreciated assets to its shareholders, or selling its assets and distributing the sales proceeds to its shareholders, incurs tax at both the corporate and shareholder levels; in contrast, an S corporation generally incurs only one level of tax on asset sales or distributions.[15] These and other recent changes have made S status increasingly advantageous for those corporations that are eligible to make the election, and have broadened the class of corporations eligible to do so. As a result, an increasing number of corporations have elected—or would benefit from electing—to conduct their business activities in S corporation form.

Another recent development in the tax law is the decreased attractiveness for many taxpayers of the installment method for reporting gain from the sale of property.[16] The Technical and Miscellaneous Revenue Act of 1988 (TAMRA)[17] imposed on many taxpayers a significant (and, subject to a phase-in transition rule, nondeductible for individuals) interest charge on the tax liability they defer by use of the installment method. The TAMRA amendments, embodied in section 453A of the Code, also provide that pledging an installment note as security for indebtedness will, in

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11. I.R.C. § 1 (1990).
12. *Id.* § 11.
13. Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S. CODE CONG. & ADMIN. NEWS (the "1986 Act").
14. General Utilities Co. v. Helvering, 296 U.S. 200, 206 (1935). The *General Utilities* doctrine provided that a corporation did not recognize gain or loss on a distribution of appreciated or depreciated property to its shareholders with respect to its stock. *Id.*
15. I.R.C. § 1368 (1990). An S corporation which was formerly a C corporation may, however, incur a corporate level tax on a distribution of certain "built-in gain" property. *Id.* § 1374. Distributions of appreciated property by corporations that elected S status before January 1, 1987 (and by certain other S corporations to the extent they qualify under a transition rule) are subject to the less onerous version of section 1374 as in effect before amendment by the 1986 Act. *Id.*; *see infra* notes 111-37 and accompanying text (discussing section 1374).
16. The installment method is a method under which "the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price." I.R.C. § 453(c) (1990).
17. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 1988 U.S. CODE CONG. & ADMIN. NEWS.

many cases, accelerate recognition of some or all of the gain that would otherwise have been deferred. These changes have in many cases diminished the tax savings previously available to taxpayers willing to sacrifice immediate liquidity for a larger after-tax return.

As the installment sale rules became more restrictive, tax planners turned to section 351 as a way to circumvent the limitations applicable to the revised installment sale rules. Generally speaking, section 351, prior to its most recent amendment, permitted a taxpayer to contribute assets to a corporation tax-free in exchange for stock or securities of the transferee corporation, provided that the transferor was in "control" of the corporation immediately after the exchange.[18] To achieve a de facto installment sale under section 351, the taxpayer would structure a transaction as follows: The party wishing to sell assets ("Seller") would transfer the assets to a newly-formed corporation ("Newco") in exchange for Newco securities and a relatively small amount of Newco (generally preferred) stock. The party seeking to buy assets ("Buyer") would contribute cash to Newco in return for Newco common stock. Provided that Buyer and Seller together held stock representing at least 80% of Newco's voting power and at least 80% of the total number of shares of each class of non-voting stock, the transaction would be tax-free to Buyer, Seller, and Newco. The Seller would end up with Newco securities secured by cash, and would recognize gain on the transferred appreciated assets only upon receipt of payments on (or sale of) the Newco securities and/or preferred stock. As the controlling shareholder, the Buyer would exercise control over the use and disposition of Newco's assets. This "end-run" around the installment sale rules permitted de facto installment sales of property that was ineligible for installment sale treatment (*e.g.*, publicly traded stock or securities) and also avoided the restrictions of newly amended section 453A.

Congress has now put an end to de facto installment sales under section 351. Pursuant to section 7203 of the Revenue Reconciliation Act of 1989,[19] all debt (whether or not it constitutes a security) received in a section 351 transaction is treated as "boot." Receipt

18. I.R.C. § 351(a) (1990).

19. Revenue Reconciliation Act, Pub. L. No. 101-239 (1989) (the "1989 Act"). Section 7203 applies to transfers made by C corporations after July 11, 1989, and by other taxpayers after October 2, 1989, unless a binding contract is in effect on the relevant date and at all times thereafter prior to the transfer. A transferor C corporation that meets the requirements of section 1504(a)(2) with respect to the transferee corporation is subject to the effective date provisions governing taxpayers other than C corporations unless the transfer is part of a plan pursuant to which the transferor subsequently fails to meet the requirements of section 1504(a)(2) with respect to the transferee.

of debt therefore triggers gain recognition, except to the extent that such recognition can be deferred under the installment sales provisions.[20]

In addition to the changes in the Code provisions governing S corporations and installment reporting, the inversion of individual and corporate tax rates, and the repeal of the *General Utilities* doctrine, the latter part of the 1980s also witnessed the imposition of new restrictions on the manner in which parties involved in the sale of assets constituting a trade or business may allocate the purchase price.[21] Introduced by the 1986 Act, and given a detailed interpretation by temporary regulations adopted in 1988,[22] section 1060 generally limits the extent to which parties may pick and choose, among the assets being sold, those assets to which certain deferred payments may be allocated for the greatest tax savings.[23]

This Article examines the impact of these recent developments on a particular category of taxpayer: the S corporation whose shareholders desire to sell some or all of the corporation's assets. While an installment sale of assets has, for many taxpayers, lost much of its previous allure, such sales may still be commercially desirable under certain circumstances—*e.g.*, where a buyer lacks ready cash or adequate borrowing power. In such a case, some S corporations may be able to achieve significant tax savings through proper planning and documentation of an installment sale. Until Congress or the Treasury provides needed clarification, however, the S corporation tax planner needs to be mindful of significant grey areas and traps

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20. The 1989 Act also did away with an analogous tax deferral mechanism under the consolidated return rules. When, in an affiliated group of corporations filing a consolidated return, a member corporation has an excess loss account ("ELA") with respect to the stock of a subsidiary—*i.e.*, when the member, in effect, has a "negative basis" in the subsidiary's stock—the member generally recognizes income from the ELA upon disposition of the subsidiary's stock. Treas. Reg. §§ 1.1502-32(e)(1), -19(a)(1) (1989). Under prior law, however, the member disposing of a subsidiary's stock could defer recognition of some or all of the ELA income by electing to apply the ELA to reduce the basis of any other stock or debt of the subsidiary held by the member immediately before the disposition. Only the remaining ELA would then be taken into income as a result of the disposition. Treas. Reg. § 1.1502-19(a)(4) (1972).

Using this mechanism, a parent corporation could defer the gain on a sale of its consolidated subsidiary as follows. The subsidiary distributed a dividend of cash and debt to its parent in an amount that exceeded the parent's basis in the subsidiary stock. The excess amount created an ELA. The parent then sold the subsidiary and elected to apply the ELA from the subsidiary's stock to the subsidiary's debt. Thus, a portion of the gain from the stock sale was deferred until the debt was repaid or disposed of. *Id.*

Section 7207(a) of the 1989 Act eliminated this tax deferral mechanism by adding new section 1503(e)[d](4) to the Code, which prohibits the transfer of an ELA to reduce the basis of debt issued by a subsidiary to its parent. The new law generally applies to dispositions after July 10, 1989. Revenue Reconciliation Act, Pub. L. No. 101-239, § 7207(b)(1) (1989).

21. *See infra* notes 147-89 and accompanying text.

22. Temp. Treas. Reg. § 1.1060-1T (1986).

23. *See infra* notes 147-89 and accompanying text.

for the unwary that exist under current law applicable to installment sales by pass-through entities in general, and by S corporations in particular.[24] This Article explores a number of problem areas that S corporation tax planners will encounter in structuring asset sales for deferred payments. Where the similarities between S corporations and partnerships are relevant, the Article takes note of problems faced by a partnership in similar circumstances.

B. *S Corporation Asset Sales*

Unlike a C corporation, an S corporation is generally not subject to corporate-level federal income tax. Items of income, gain, loss, credit, or deduction incurred by the S corporation pass through to its shareholders according to their respective interests in the corporation, and the shareholders are taxed as though they incurred these items directly rather than through the interposed corporation.[25] Generally speaking, each shareholder's stock basis increases to reflect the corporation's income and decreases to reflect the corporation's loss.[26] Shareholder distributions by an S corporation are generally treated first as a tax-free return of stock basis if the corporation has no accumulated earnings and profits.[27] In the case of an S corporation with accumulated earnings and profits, the rules governing taxation of shareholder distributions are more complicated but still generally allow a distribution that is treated in part as a return of basis.[28]

An asset sale is generally more advantageous to the buyer than a stock sale because the asset purchaser obtains a stepped-up basis in the purchased assets, thereby entitling the purchaser to additional depreciation deductions; these additional deductions may enable the seller to exact a higher purchase price. Unlike C corporation shareholders, the shareholders of an S corporation receive an in-

24. Although an asset sale by an S corporation will trigger only a single level of tax under federal law (subject to sections 1374 and 1375, as discussed at Part III *infra*, and section 1371(d)(2)), not all states recognize S status. *See Multistate S Corporations Endure Maze of State Laws*, 70 J. TAX'N 174, 175 n.4 (1989) (indicating states that recognize S status).

25. I.R.C. § 1366(b) (1990).

26. *Id.* § 1367. Specifically, stock basis increases to reflect the corporation's income and any excess of deductions for depletion over the basis of the property subject to depletion, *id.* § 1367(a)(1); stock basis decreases to reflect corporate distributions excludable from the shareholder's gross income, corporate losses, corporate deductions (the separate treatment of which could affect the tax liability of any shareholder), corporate expenses not deductible by the corporation or properly chargeable to its capital account, and the shareholder's depletion deduction for oil and gas property held by the corporation to the extent the deduction does not exceed the shareholder's proportionate share of the adjusted basis of the property. *Id.* § 1367(a)(2).

27. *Id.* § 1368(b)(1).

28. *Id.* § 1368(b)(2).

crease in their stock basis that reflects their taxable income from the corporation's gain on an asset sale.[29] Thus, subject to certain exceptions,[30] the gain on the sale of an S corporation's assets is not subject to double taxation, thereby making shareholders of an S corporation amenable to asset dispositions.

In contrast, regardless of whether the buyer is an individual or a corporation, and regardless of whether a section 338 election is made, a purchaser of the stock of an S corporation is unable to step up asset basis without incurring a second level of tax.[31] A well advised buyer seeks to shift some or all of this increased tax burden to the seller, typically in the form of a purchase price reduction. If an equally well-advised seller refuses to accept his tax burden, the buyer, absent unusual circumstances, will not elect to step up the basis of the acquired assets. Asset disposition transactions by S corporations, therefore, offer a unique opportunity in a post-*General Utilities* repeal world for a buyer to step up asset basis without incurring corporate level tax, and the seller may command a higher purchase price as a result.[32]

A tax-free reorganization[33] of the S corporation can offer substantial tax savings over a taxable sale of either stock or assets. However, a reorganization is a realistic option only for those shareholders willing to accept consideration largely or entirely in the form of stock of the acquiring corporation. In addition, a reorganization does not provide the buyer a stepped-up asset basis, nor can the buyer achieve such a step-up by making a section 338 election, since the election is not available with respect to stock acquired other than by purchase. The shareholders also are taxed on their gain to the extent of any "boot" they receive (although gain recognition can be deferred to the extent that the boot includes an installment obligation).[34] Thus, for S corporation shareholders who no

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29. *Id.* § 1367(a)(1).

30. *See infra* Part III.

31. Asset basis can be stepped up by actually liquidating the corporation or by electing deemed liquidation treatment under section 338. Either choice causes the corporation to recognize taxable gain on its appreciated assets. I.R.C. § 336 (1990) (actual liquidations) and *id.* §§ 338, 1362(d) (S corporation becomes a C corporation prior to deemed liquidation).

32. A taxable stock sale may nonetheless be an attractive option to the seller in certain circumstances. For example, if an asset sale subjects the S corporation to a corporate-level tax under I.R.C. § 1374, *see infra* Part III, or if the shareholders' stock basis is significantly higher than the corporation's asset basis, a stock sale may be advisable.

33. *See* I.R.C. § 368(a)(1) (1990).

34. *Id.* §§ 356(a), 453(f)(6). As used throughout this article, the terms "installment note," "installment debt," and "installment obligation" refer to an evidence of indebtedness (other than a third party obligation) received in exchange for property and calling for one or more principal payments to be received after the close of the taxable year in which the disposition occurs. *See id.* § 453(b)(1) (defining "installment sale").

longer wish to subject all or a substantial part of their investment to the risks of an enterprise, a taxable sale of stock or assets is preferable, and, for the reasons set forth above, in most cases an asset sale is the optimal route.

While a sale of assets for cash offers maximum liquidity and relatively low risk, in many cases a buyer simply does not have sufficient funds for an all-cash deal, and may be unable to offer non-cash consideration (such as stock or securities) that is acceptable to the seller. Moreover, if the non-cash consideration causes an immediate recognition of gain, the selling corporation's shareholders may be unable to fund the resulting tax liability. Thus, as a matter of commercial reality, in many transactions the shareholders of the selling corporation may have little choice but to structure the transaction on a deferred payment basis that qualifies for installment method reporting.

Debt that qualifies for installment reporting frequently can offer significant tax savings and relatively low risk to those shareholders who are willing to sacrifice some liquidity to achieve those savings. As discussed in greater detail in Part II, a taxpayer that receives up to $5 million of installment debt in a given taxable year can receive a market (or better) rate of interest on the pre-tax proceeds of the sale, whereas receipt of cash followed by investment of the cash generates investment earnings only on the after-tax cash amount. Thus, an installment note can, under appropriate circumstances, offer a significantly higher after-tax yield than would immediate receipt of its face amount in cash followed by investment of the after-tax proceeds. This benefit, in fact, was the impetus that stirred Congress to enact section 453A, under which, as discussed in Part II, this advantage of installment reporting diminishes with receipt of larger amounts of installment debt.[35]

Installment debt also is frequently utilized when buyer and seller are unable to agree on the value of the assets sold. In that case, they may decide that some or all of the consideration should take the form of a contingent deferred payment obligation, or "earn-out." This allows the purchase price to increase or decrease to reflect the actual income produced by the assets sold. An "earn-out" may qualify for installment reporting even though the amount due and the timing of the payments are not fixed.[36]

35. *See infra* notes 44-58 and accompanying text.
36. *See* Temp. Treas. Reg. § 15A.453-1(c) (as amended in 1981).

II. INSTALLMENT REPORTING

A. *Generally*

Installment method reporting of income is available for any disposition of property (subject to exceptions for certain types of property)[37] in which "at least one payment is to be received after the close of the taxable year in which the disposition occurs."[38] It is not necessary that the first payment be delayed a full year; it is necessary only that the seller's taxable year of sale (whether fiscal or calendar) end between the closing date of the sale and the due date of any portion of the purchase price. Thus, the first (or, in the case of a lump sum, the only) payment could take place on the first business day after the sale closes if the closing takes place on the last day of the seller's taxable year. When the installment method is available, its application to a given disposition is automatic unless the seller elects out.[39]

Generally speaking, the income which a seller recognizes in a taxable year from a sale to which the installment method applies equals that proportion of the payments received in that year which the gross profit from the sale bears to the total contract price.[40] In contrast, where the installment method is unavailable, a seller receiving deferred payments generally recognizes income upon receipt of the buyer's evidence of indebtedness, although the amount of that income depends on whether the seller is a cash or accrual method taxpayer.[41] Because the seller generally insists on an installment obligation that bears at least a market rate of interest,[42] the seller receiving installment debt is in effect investing pre-tax dollars at the market rate. Under current law, a seller receiving no more than $5 million in installment debt in one taxable year receives the full bene-

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37. *See infra* notes 138-46 and accompanying text.
38. I.R.C. § 453(b)(1) (1990).
39. *Id.* § 453(a), (d).
40. *Id.* § 453(c).
41. The general rule is that accrual method taxpayers must accrue the face amount of the indebtedness and cash method taxpayers must include in income the fair market value of the indebtedness. *See* Rev. Rul. 79-292, 1979-2 C.B. 287, amplified by 89-122, 1989-2 C.B. 200, and cases cited therein. An exception exists for certain "open transactions," in which the seller is allowed to recover basis first. *See* Burnet v. Logan, 283 U.S. 404, 412 (1931). The Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 1980 U.S. CODE CONG. & ADMIN. NEWS (94 Stat.) 2247 (the "1980 Act"), and the temporary regulations thereunder, severely limited the availability of this exception, although the scope of these restrictions is still unclear. *See* S. REP. No. 1000, 96th Cong., 2d Sess. 24 (1980); Temp. Treas. Reg. § 15A.453-1(c), (d) (as amended in 1981).
42. The seller is taxed at ordinary income rates on the interest received (or deemed received) on the installment note. Interest may be deemed received even when a note does not bear stated interest. *See* I.R.C. §§ 483, 1272-1274 (1990) (detailing imputed interest rules).

fit of this tax deferral; taxpayers receiving greater amounts of installment debt in one year have a reduced advantage, as discussed in greater detail below.[43]

The TAMRA amendments to section 453A have limited the economic advantages of installment sales for many taxpayers. When new section 453A applies to an installment sale of property, then for each year the installment note remains outstanding, the holder of the obligation must pay an interest charge on a portion of the deferred tax liability.[44] In the case of an individual taxpayer—including an S corporation shareholder or a partner in a partnership—this interest is personal interest and is therefore nondeductible.[45] The interest rate is "the underpayment rate in effect under section 6621(a)(2) for the month with or within which the taxable year ends."[46] The portion of the deferred tax liability to which the interest charge applies is a fraction (called the "applicable percentage") which is determined in the taxable year in which the installment obligation arises and which equals the aggregate "face amount"[47] of that obligation plus any other installment obligations arising in (and outstanding at the close of) that taxable year *minus* $5 million, divided by the aggregate face amount of all of those obligations.[48]

For example, assume that on the first day of her taxable year, Ms. X receives installment debt with a total face amount of $20 million in exchange for property held at a zero basis, and that Ms. X receives no principal payments on that obligation before the close of her year. Ms. X's applicable percentage is (20-5)/20 or 75%. Assuming that a 28% individual income tax rate applies, Ms. X's total amount of deferred tax liability for the year is .28 multiplied by $20 million or $5.6 million. At an underpayment rate of 11%, Ms. X's nondeductible interest liability under section 453A is .11 times .75 multiplied by $5.6 million, or $462,000. If the interest rate on the installment note also equaled 11%, Ms. X would have received a pre-tax return on the deferred tax of $616,000, but an after-tax return of only .72 multiplied by $616,000, or $443,520. Ms. X's net

43. *Id.* § 453A(d).
44. Id. § 453A(c).
45. *Id.* § 163(h); Temp. Treas. Reg. § 1.163-9T(b) (1987); Conference Committee Report on Pub. L. No. 100-203, *reprinted in* 4 Stand. Fed. Tax Rep. (CCH) ¶ 2885A, at 35,513 (1989). This rule of non-deductibility is subject to a gradual phase-in through taxable years beginning in 1990. I.R.C. § 163(h)(5) (1990).
46. I.R.C. § 453A(c)(2) (1990). The section 6621(a)(2) underpayment rate is three points over the Federal short-term rate, which is a rate determined by the Secretary of the Treasury on a quarterly basis in accordance with sections 1274(d) and 6621(b)(3).
47. The term "face amount" is undefined, but should exclude both stated interest and interest that is imputed under sections 483 and 1272-1274.
48. I.R.C. § 453A(c)(1)-(4) (1990).

cost of using installment reporting, therefore, is $18,480, which represents the amount by which the section 453A interest charge exceeds the after-tax return on the deferred tax payment.[49]

In addition to the interest charge imposed on the deferred tax liability when new section 453A applies to an installment note, if the holder of the note pledges the note as security for indebtedness, the net proceeds of the secured indebtedness are treated as payment on the installment note, thus accelerating a portion of the tax liability that otherwise would have been deferred.[50] Any amounts deemed paid on the note pursuant to the pledge rule are subtracted from the face amount of the obligation for purposes of determining whether the $5 million threshold is exceeded.[51] Such deemed payments also reduce the interest charge by decreasing the amount of unrecognized gain on which the taxpayer's deferred tax liability is calculated under section 453A(c)(3).

The section 453A pledging rule applies to any obligation arising from a disposition of property under the installment method[52] if the sales price of the property exceeds $150,000.[53] The interest charge, however, applies to such an obligation only if (1) the obligation is outstanding at the close of the taxable year in which the disposition of property occurs, and (2) the face amount of all such obligations of the taxpayer arising during (and outstanding at the close of) such taxable year exceeds $5 million.[54]

The interest charge imposed by section 453A may eliminate much of the tax advantage of installment reporting for taxpayers that exceed the $5 million threshold. It does not, however, eliminate all the benefit of installment reporting if the interest rate on the install-

49. The section 453A interest charge on deferred taxes apparently is not prorated to reflect the point in the taxable year at which the installment sale occurs. Thus, had Ms. X sold her property on the last day of her taxable year, her section 453A interest charge still would be $462,000, but her investment earnings for that year would be minimal.

50. I.R.C. § 453A(d)(1) (1990). The payment is deemed to be received as of the later of the date on which the pledging occurs or the date on which the taxpayer receives the proceeds of the indebtedness. *Id.* § 453A(d)(1)(A)-(B).

51. H.R. REP. No. 495, 100th Cong., 1st Sess. 929 (1988). A taxpayer receiving $6 million of debt in a sale of property held at a zero basis would incur the interest charge and have an applicable percentage of (6-5)/6 or 16.67%. That taxpayer could avoid the interest charge completely by discounting or pledging $1 million of the note before the close of the taxable year. This assumes, of course, that the note is divisible (a feature which could be negotiated between buyer and seller at the time of the original sale of property) and that the taxpayer is prepared to pay the tax on the $1 million of gain triggered by the pledge or disposition of the note.

52. The term "installment method" as used in section 453A is undefined. Presumably it refers to the tax accounting method authorized by section 453(a)(1) for installment sales.

53. I.R.C. § 453A(b), (d) (1990).

54. Id. § 453A(b)(1)-(2). Exceptions and special rules exist for certain farm property, timeshares, and residential lots. *Id.* § 453A(b)(3)-(4).

ment note is greater than the applicable percentage multiplied by the underpayment rate, divided by 1 minus the applicable tax rate. For example, in the case of Ms. X above, if the rate on the installment note is increased to more than 11.4583% (*i.e.*, .75 multiplied by 11% divided by .72), the installment method still provides Ms. X with an economic advantage. Of course, the higher the applicable percentage, the greater the interest rate on the installment note must be for the seller to benefit from the installment sale.[55]

Sellers that have sufficient cash to cover their immediate tax liability, and that would otherwise incur a net cost under section 453A, may prefer to elect out of the installment reporting rules[56] and report their entire gain in the year of sale to avoid the section 453A interest charge. Individual sellers (including individuals owning a pass-through entity that made an installment sale) short on liquidity, however, may find that the cost of borrowing to pay their taxes (a nondeductible cost unless the borrowed funds can be traced to a nonpersonal disbursement in accordance with the interest tracing rules in Temp. Treas. Reg. § 1.163-8T) exceeds the section 453A interest charge, or they may have difficulty borrowing at all. Likewise, certain installment obligations realistically may not be marketable, or only at a steep discount.[57] Thus, even when the interest charge makes the installment method less advantageous than under prior law, it may still be the lesser of two evils for some taxpayers. For these taxpayers, if the section 453A interest charge can be reduced by proper tax planning, installment reporting begins to regain some of its former luster. Moreover, as noted earlier, for sellers who are able to negotiate a sufficiently high interest rate (perhaps at a cost of lowering the sales price), reporting on the installment method still provides a benefit.

The application of section 453A's $5 million threshold to a seller that is an individual or a C corporation is relatively straight-forward. In the case of pass-through entities such as S corporations and partnerships, however, the application of section 453A is unclear in several important respects. As discussed below, the position taken by the Internal Revenue Service ("IRS" or the "Service") in applying

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55. The examples used throughout the text assume that the section 453A interest rate remains stable. In fact, the rate is likely to vary from year to year because it reflects the underpayment rate for the month in which the taxable year ends. I.R.C. § 453A(c)(2)(B) (1990). A seller anticipating an increase in the underpayment rate during the term of the note may wish to negotiate a higher (or variable) interest rate to compensate for this increase.

56. *See id.* § 453(d) (outlining procedure for electing out of installment method).

57. Under temporary regulations enacted in 1981, even promises to pay that are not cash equivalents will trigger gain recognition if the seller elects out of installment reporting. Temp. Treas. Reg. § 15A.453-1(d)(2) (as amended in 1981).

section 453A to pass-through entities permits some pass-through entities to acquire and hold significantly more than $5 million in installment obligations without incurring the section 453A interest charge.[58] For an S corporation (or partnership) that can take advantage of these rules, therefore, installment sales may still offer significant planning opportunities. The remainder of this Article outlines those opportunities and identifies those taxpayers that can take advantage of them, while alerting tax planners to certain unresolved issues and traps for the unwary that may be encountered en route.

B. *Applying Section 453A to Pass-Through Entities*

1. *The aggregate approach*

As amended by TAMRA, section 453A(c)(5) authorizes the Secretary of the Treasury to prescribe regulations providing, among other things, for the application of the interest charge in the case of pass-through entities (*i.e.*, S corporations and partnerships), but it offers no substantive guidance, and the Secretary has yet to issue any proposed regulations. The legislative history of the TAMRA amendments to section 453A is also unavailing. However, the Conference Committee Report on the Revenue Act of 1987, which first imposed the section 453A interest charge on a limited class of installment sales (a class later expanded by TAMRA), contains the following statement: "[T]he conferees anticipate that the regulations relating to pass-through entities will treat the installment obligations of a partnership as owned directly by the partners in proportion to each partner's share in the partnership."[59] Although the Conference Committee Report contains no comparable statement regarding S corporations, based on the broad reference to "pass-through entities" in section 453A(c)(5), it seems clear that in 1987 Congress intended to apply a similar pro rata allocation to S corporations holding installment notes.[60] As discussed below, the Service has endorsed this policy in two subsequent IRS pronouncements. Such an "aggregate" approach treats the assets of a pass-through entity as owned pro rata by the entity's partners or shareholders. Under this approach, an S corporation shareholder's interest in the

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58. *See infra* note 61 and accompanying text.

59. H.R. REP. No. 495, *supra* note 51, at 930.

60. The Conference Committee Report, likewise, tracks the language of section 453A(c)(5): "The Treasury Secretary is authorized to prescribe regulations that carry out the purposes of the interest rule including such regulations as may be necessary to address the treatment of short taxable years, installment obligations with contingent payments, and pass-through entities." H.R. REP. No. 495, *supra* note 51, at 930.

installment obligations received by the corporation corresponds to that shareholder's percentage ownership of the corporation's stock.

According to the Service's two pronouncements on applying the section 453A interest charge to partnerships and S corporations, the $5 million threshold applies, and the interest calculations are made, at the partner or shareholder level.[61] This appears to require aggregation of the partner's or shareholder's pro rata share of installment obligations arising from transactions of the partnership or S corporation plus any other installment obligations held by the partner or shareholder (arising from transactions as an individual or by virtue of interests held in other pass-through entities). Thus, the tax planner must look beyond the particular transaction at issue to assess whether and to what extent the transaction may cause a partner or shareholder to incur interest liability under section 453A.

The bright side of this "aggregate" approach is that application of the threshold test at the partner or shareholder level means that each partner or S corporation shareholder has a separate $5 million threshold. Thus, if a hypothetical S corporation has thirty-five equal shareholders (the maximum number of shareholders permitted under the Code),[62] none of whom receives during the taxable year any other installment obligation to which section 453A applies (*i.e.*, an obligation arising from a disposition of property on the installment method for a selling price in excess of $150,000), then our hypothetical S corporation could receive up to $175 million in installment debt in any one taxable year without triggering the section 453A interest charge.[63] In the case of a partnership, as to which the Code imposes no maximum number of owners, there appears to be no upper limit to the aggregate face amount of the installment note(s) that a partnership may receive in one taxable year without incurring interest liability under section 453A, provided that no

61. I.R.S. Notice 88-81, 1988-2 C.B. 397; *see* Announcement 89-33, 1989-10 I.R.B. 30 (clarifying Notice 88-81). Notice 88-81 is an "administrative pronouncement" within the meaning of Treas. Reg. § 1.6661-3(b)(2) and thus may be relied on by taxpayers as "substantial authority" under I.R.C. § 6662(d)(2)(B)(i) (1990). I.R.S. Notice 88-81, 1988-2 C.B. 397, 397-98.

62. I.R.C. § 1361(b)(1)(A) (1990).

63. Section 453A(b)(2) provides that, except as regulations may otherwise provide, "all persons treated as a single employer under subsection (a) or (b) of section 52 shall be treated as one person" for purposes of applying the $5 million threshold. *Id.* § 453A(b)(2). Notwithstanding the fact that the term "person(s)" does not appear anywhere else in section 453A, it appears that Congress intended to aggregate the interests of taxpayers that constitute a "single employer" in applying the threshold test. Section 52(a) treats members of the same controlled group of corporations as a single employer, and section 52(b) treats trades or businesses (whether or not incorporated) under common control as a single employer. *Id.* § 52(a)-(b). Thus, to the extent that partners or S corporation shareholders have such control relationships, their interests must be aggregated for purposes of the threshold test.

partner individually exceeds the $5 million threshold. Thus, in contrast to individuals and to C corporations, which are subject to the section 453A interest charge upon receipt in one taxable year of more than $5 million in installment debt to which section 453A applies, pass-through entities with sufficiently dispersed ownership enjoy a distinct advantage.

An issue also exists as to whether the $150,000 sales price threshold should be tested at the entity or owner level. In other words, if an S corporation or partnership with thirty-five equal shareholders or partners sells an asset for $5.25 million, does each shareholder or partner treat this as a sale for $150,000 or for $5.25 million? In the former case, section 453A would not apply, whereas in the latter case it would. Although consistency might argue for applying the test at the same level as the $5 million threshold test—*i.e.*, at the owner level, according to each owner's pro rata interest in the S corporation (or partnership)[64]—there is no support for this position in the legislative history of section 453A. In contrast to the 1987 Conference Committee's express instructions regarding the deferred interest charge to "treat the installment obligations of a partnership as owned directly by the partners in proportion to each partner's share in the partnership,"[65] neither the 1987 nor the 1988 legislative history of section 453A suggests taking a comparable approach to the selling price of the underlying assets. In fact, section 453A(b)(5) indicates that the $150,000 test applies on a per-transaction basis. Thus, the better answer—and the one most likely to be adopted by the Treasury—is to apply the $150,000 test at the entity level.

2. *Timing issues*

a. *Applicable percentage*

The Conference Committee Report on the Revenue Act of 1987 indicates that once the "applicable percentage" of an installment note to which section 453A applies is determined, "[t]his percentage will not change as payments are made (or deemed made under the pledge rule) in subsequent taxable years."[66] Thus, while the amount of unrecognized income subject to the interest charge decreases as payments are made (or deemed made), the applicable percentage used to compute the interest charge on this income does not decrease.

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64. *Cf.* H.R. REP. No. 495, *supra* note 51, at 930.
65. *Id.*
66. *Id.*

Nor does it appear, based on the statutory language, that the applicable percentage increases in subsequent taxable years even if the taxpayer's installment note holdings increase during those years. Section 453A(c)(4) defines "applicable percentage" as follows:

> For purposes of this subsection the term "applicable percentage" means, with respect to obligations *arising* in any taxable year, the percentage determined by dividing—
> (A) the portion of the aggregate face amount of *such* obligations outstanding as of the close of *such* taxable year in excess of $5,000,000, by
> (B) the aggregate face amount of *such* obligations outstanding as of the close of *such* taxable year.[67]

Thus, the applicable percentage with respect to Note A arising in year one should not increase as a result of Note B arising in year two, since the applicable percentage with respect to Note A is determined only in the year in which Note A arises. Likewise, installment debt arising in a *prior* taxable year should not affect the calculation of the applicable percentage for later-acquired debt even if the prior debt is still outstanding when the later debt is acquired.

b. Threshold test date

Similarly, although the Code and legislative history are murky at best, it appears that the determination of whether the interest charge applies to an installment note *at all* is to be made only once, in the taxable year in which the note arises, and that the determination should take account only of notes arising during that year. Section 453A(b)(2) provides that the interest charge applies to an obligation "arising during a taxable year" but only if "such obligation is outstanding at the close of such taxable year" and if "the face amount of all obligations [from installment sales of property for more than $150,000] which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000."[68]

One problem in interpreting this language lies in determining whether the phrase "arose during, and . . . outstanding as of the close of, such taxable year" in section 453A(b)(2)(B) refers to two categories of obligations—*i.e.*, those which arose during the year (regardless of when they are pledged, paid off or disposed of), and those which are outstanding as of the close of the year (regardless of when they arose)—or only one category of obligations—*i.e.*, those which arose during the year and remain outstanding as of the close

67. *Id.* § 453A(c)(4) (emphasis added).
68. *Id.* § 453A(b)(2).

of the year. The difference is significant. Applying the first interpretation, the $5 million threshold is cumulative, and does not allow a taxpayer to *hold* more than $5 million of installment debt subject to section 453A without incurring the interest charge. Applying the second interpretation, the taxpayer may accumulate an unlimited amount of installment debt described in section 453A without incurring the interest charge, provided no more than $5 million is acquired in any one taxable year.

Several passages in the legislative history of the 1987 Act suggest that the second interpretation is correct.[69] In discussing the modifications made in the rules governing installment sales of real property by non-dealers, the Conference Committee Report states: "[A]n interest charge is imposed on the tax that is deferred under the installment method to the extent the amount of deferred payments arising from all dispositions of such real property during any year exceeds $5 million."[70] The Conference Committee Report authorizes the Secretary of the Treasury to prescribe regulations that carry out the purposes of the interest rule, "including such regulations as may be necessary to address the treatment of short taxable years."[71] In particular, the Report notes: "The conferees anticipate that the regulations relating to short taxable years will proportionately reduce the amount of interest payable and the $5 million threshold for any short taxable year."[72] A reduction in the threshold for short taxable years would be unnecessary if the threshold amount were intended to be cumulative.

Perhaps the best argument for viewing the threshold as non-cumulative is that under the opposite interpretation the reference in section 453A(b)(2)(B) to obligations that "arose during, and are outstanding as of the close of, such taxable year" would refer to two separate categories of debt—(1) all debt that arose during the year at issue, and (2) all debt that was outstanding at the end of that year—which are overinclusive. Under this approach, the interest charge would apply even to obligations that arise during the taxable year and that are completely (or even partially) paid off (or pledged or disposed of) before the end of the year. Installment obligations that are paid off, pledged, or disposed of do not defer gain recognition at all, but result instead in gain recognition in the year they are paid off, pledged, or disposed of—in this case, the same year they

69. H.R. REP. No. 495, *supra* note 51, at 928.

70. *Id.*

71. *Id.*

72. *Id.* at 930.

arose. It would therefore make no sense to include them in calculating the $5 million threshold for the year in which they arose.

If a taxpayer makes a series of installment sales, each in a separate taxable year, section 453A allows the taxpayer to receive up to $5 million in installment notes in each taxable year without incurring an interest charge. Thus, under appropriate circumstances, a taxpayer could receive up to $10 million in installment debt without penalty in separate transactions that occur only moments apart. That is, a taxpayer could sell property for a $5 million installment note on the last day of taxable year one, and then sell other property for a $5 million installment note on the first day of taxable year two, without crossing the $5 million threshold for either taxable year. There is no indication whether Congress intended to permit this result or whether (and, if so, under what circumstances) the Service or the Treasury will disallow such treatment.[73] For our hypothetical S corporation with thirty-five equal shareholders, such a two-stage strategy doubles to $350 million the total face amount of the installment notes the corporation could receive from a sale of its assets, without requiring more than a few moments to pass between the transactions. The same effect could be achieved on a grander scale by a partnership with widely dispersed ownership.

Many pass-through entities do not, of course, have the widely dispersed ownership assumed in this hypothetical. This example merely illustrates the extreme situation. In some cases, an interest liability arises for holders of larger pro rata interests but not for the holders of smaller interests in the pass-through entity. That problem and some possible solutions are discussed in Part II.B.2.d.[74]

c. *Identifying the "taxable year"*

Other ambiguities which contribute to the problem of applying section 453A to a pass-through entity arise from Congress' recurrent use in that section of the term "taxable year" unaccompanied by any indication whether the taxable year at issue is the owner's year or the entity's year. Some partnerships and S corporations use a taxable year that is different from the taxable year of some or all of the partners or shareholders.[75] Indeed, individual partners and

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73. Section 453A(b)(5) provides that, for purposes of determining whether the sales price of property exceeds $150,000, "all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange." *Id.* § 453A(b)(5); *see also* H.R. REP. No. 495, *supra* note 51, at 929 n.6. No comparable language calls for aggregation of related transactions for purposes of the $5 million threshold.

74. *See infra* notes 83-96 and accompanying text.

75. Sections 441, 706, and 1378, as amended by section 806 of the 1986 Act, generally require S corporations, partnerships, and personal service corporations to conform their taxa-

shareholders[76] may have different taxable years from one another as well. As a result, until Congress or the Treasury clarifies the meaning of "taxable year" in applying section 453A to pass-through entities, taxpayers for whom different interpretations of the phrase will yield different tax results should proceed with caution.

The first ambiguous use of the term "taxable year" occurs in section 453A(b)(2), which provides in relevant part:

> (2) Special Rule for Interest Payments.—For purposes of subsection (a)(1), this section [453A] shall apply to an obligation described in paragraph (1) arising during a taxable year only if—
>
> (A) such obligation is outstanding as of the close of such taxable year, and
>
> (B) the face amount of all obligations of the taxpayer described in paragraph (1) which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000.[77]

The term appears again at subsection (c)(4):

> (4) Applicable Percentage.—For purposes of this subsection, the term "applicable percentage" means, with respect to obligations arising in any taxable year, the percentage determined by dividing—
>
> (A) the portion of the aggregate face amount of such obligations

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ble years to the taxable years of their owners. However, the rules make an exception for entities that establish, to the satisfaction of the Secretary of the Treasury (the "Secretary"), a business purpose (which may not be the deferral of shareholder or partner income) for having a different taxable year. I.R.C. §§ 441(i), 706(b)(1)(C), 1378(b) (1990). The Secretary has provided for expedited approval of non-conforming taxable years only where the entity's year is a "natural business year." Rev. Proc. 87-32, 1987-2 C.B. 396, 396. A particular fiscal year is a "natural business year" if, based on data from the three fiscal years preceding the taxpayer's request for approval of such fiscal year, it appears that at least 25% of the entity's gross receipts are attributable to the last two months of such year. *Id.* at 399. There are no expedited approval provisions for non-conforming years based on business purposes other than the existence of such a natural business year, although entities are not foreclosed from seeking approval for such years. *Id.* at 401. In addition, entities which received approval for non-conforming years under the less stringent standard of Rev. Proc. 74-33, 1974-2 C.B. 489, may continue to use such years without satisfying the new 25% test. H.R. REP. No. 841, 99th Cong., 2d Sess. at II-319 (1986); Rev. Proc. 87-32, 1987-2 C.B. at 398.

Alternatively, an S corporation or partnership may elect to have a non-conforming taxable year if, generally speaking, the non-conforming year defers recognition of no more than three months of income (compared to a conforming year). I.R.C. §§ 444(a), (b) (1990). Such election generally produces little or no tax savings, however, since the entity is required to make a non-interest-bearing deposit representing the aggregate anticipated tax liability of its owners (based on prior year's income) by April 15 following the start of the non-conforming year. *Id.* § 7519. A personal service corporation may also make a section 444 election, but the election subjects it to the limitations on deductions imposed by section 280H. *Id.* § 280H(a).

76. Because an S corporation usually has only individuals as shareholders, only rarely would such a corporation have a non-calendar-year shareholder. This could occur, for example, if one shareholder were a decedent's estate or if an individual shareholder elected not to use a December 31 year-end.

77. I.R.C. § 453A(b)(2) (1990).

outstanding as of the close of such taxable year in excess of $5,000,000, by

(B) the aggregate face amount of such obligations outstanding as of the close of such taxable year.[78]

As noted earlier, the IRS's two pronouncements relevant to the section 453A interest charge require the threshold $5 million calculation to be made at the owner level.[79] Logically, therefore, the owner-level calculation should encompass all installment obligations subject to section 453A that arise during and are outstanding at the close of the entity's taxable year to the extent of that owner's interest in the obligations.[80] That is, a 20% shareholder would take into account 20% of each installment obligation held by the S corporation.

Presumably, for purposes of measuring the amount of installment debt held through a pass-through entity, the "taxable year" at issue should be the entity's taxable year ending with or within the owner's taxable year for which the calculation is to be made. Thus, if an S corporation's taxable year ends on May 31, 1991, an individual calendar-year shareholder must add his or her pro rata share of the entity's applicable installment debt arising after May 31, 1990 and outstanding as of May 31, 1991, to any applicable installment debt held on December 31, 1991 by the shareholder either directly, *i.e.*, not held through a pass-through entity, in which case only debt arising after December 31, 1990 would count, or by virtue of the shareholder's interest in any other pass-through entity in which case only debt arising in the entity's taxable year ending during 1991 would count. If a taxpayer owns interests in several pass-through entities acquiring applicable installment debt, then the shareholder's level of newly-acquired installment debt will increase periodically throughout the shareholder's taxable year as the taxable year of each entity closes, and the shareholder's section 453A interest calculation for the year will be based on the aggregate of these amounts at the end of the shareholder's taxable year.

To illustrate: Mr. A, a calendar year taxpayer, owns 50% of the stock of Q, an S corporation which has a May 31 taxable year. Q has

78. *Id.* § 453A(c)(4).

79. *See supra* note 61 and accompanying text.

80. Notice 88-81 provides:

A pass-through entity shall provide its owners with information needed to calculate the amount of interest on deferred tax liability under section 453A(c), including the owner's share of the amount of gain that has not been recognized by the entity as of the close of the pass-through entity's taxable year and the face amount of each of the entity's nondealer obligations outstanding as of the close of the pass-through entity's taxable year.

I.R.S. Notice 88-81, 1988-2 C.B. 397, 398.

$8 million in section 453A installment debt arising on June 30, 1990 and outstanding as of May 31, 1991. Half of this—$4 million—should be attributed to Mr. A in calendar year 1991 for section 453A purposes. Mr. A receives (individually) another $3 million in section 453A installment debt on November 1, 1991, and the full principal amount of this debt remains outstanding on December 31, 1991. Although there is no guidance on this point, presumably Mr. A must aggregate the two amounts and pay section 453A interest based on the unrecognized income at the close of the 1991 calendar year with respect to the $7 million of installment debt. If, instead, Mr. A received the $3 million individually-owned obligation during the 1990 calendar year, that debt should be counted in determining Mr. A's section 453A liability for calendar year 1990, the taxable year in which that debt arose, rather than for calendar year 1991. In that case, if Mr. A receives no other installment debt in either calendar year, then Mr. A should not owe interest under section 453A for either year.

Under this approach, in the case of entity-owned installment debt, "taxable year" refers to the entity's taxable year ending with or within the individual's taxable year, and in the case of individually-owned installment debt, "taxable year" refers to the individual's taxable year. In the above example, this interpretation forecloses Mr. A from arguing that his share of entity-owned debt (arising in 1990) and his individually-owned debt (arising in 1991) "arose during" different taxable years and therefore cannot be aggregated for purposes of calculating the $5 million threshold.[81]

A related question is the meaning of the phrase "gain . . . which has not been recognized as of the close of such taxable year" in section 453A(c)(3), which provides:

> (3) Deferred Tax Liability.—For purposes of this section, the term "deferred tax liability" means, with respect to any taxable year, the product of -
> (A) the amount of gain with respect to an obligation which has not been recognized as of the close of such taxable year, multiplied by
> (B) the maximum rate of tax in effect under section 1 or 11, whichever is appropriate, for such taxable year.[82]

In the case of a fiscal year entity with a calendar year owner, gain in

81. Likewise, the interest rate is the underpayment rate in effect at the end of the taxable year of sale. *See* I.R.C. § 453A(c)(2)(B) (1990). Because the relevant tax underpayment is the owner's rather than the entity's, "taxable year" for this purpose ought to refer to the owner's year in which the gain from a cash sale would have passed through. Again, there is no authority construing the statutory language.

82. I.R.C. § 453A(c)(3) (1990).

some cases does not pass through to the owner until the calendar year after the calendar year in which the sale occurs, regardless of whether the sale is for cash or debt. In such a case, gain recognition is deferred for one year for reasons unrelated to installment reporting. A literal reading of the phrase "gain with respect to an obligation which has not been recognized" would reap a windfall for the Treasury. The only sensible interpretation is to read the phrase as referring to gain which has not been recognized solely by virtue of installment method reporting.

d. Changes in pro rata interests

(i) After the installment sale

There is no authority addressing the impact, if any, of changes in shareholders' pro rata interests in taxable years after the year in which an installment note arises. If a particular shareholder exceeds the $5 million threshold in Year 1, and receives no payments of principal in Year 2 but reduces his or her equity interest in the corporation during Year 2 so that, if the shareholder's new pro rata interest in the corporation is considered, he or she would no longer exceeds the $5 million threshold, does section 453A still apply? And, if so, does the applicable percentage remain the same?

Questions of whether and when to re-test for the applicability of section 453A also arise under the reverse scenario, in which a shareholder does not cross the threshold in the year in which the note arises, but will cross that threshold if re-tested in a subsequent taxable year. As discussed later, similar questions arise if the corporation makes a non-pro rata distribution of an installment note in a liquidating distribution in which, by operation of sections 453(h) and 453B(h), the deferred gain on the note is not accelerated.[83]

The same questions arise in the partnership context.[84] Here, however, there is the added—and, thus far, unanswered—question of whether special allocations can be used to manipulate the respective interests of each partner in the partnership's installment debt.[85] The language of the 1987 Conference Committee Report indicates that the regulations under section 453A should treat installment debt as owned pro rata by the partners "in proportion to each part-

83. *See infra* Part V.

84. *See* I.R.C. § 731 (1990) (stating extent to which gain or loss is recognized on distribution by partnership to partner).

85. A partnership agreement may allocate the partnership's items of income, gain, loss, deduction, or credit in a way that does not correspond to partners' respective interests in the partnership. Such "special allocations" are governed by section 704 and the regulations thereunder.

ner's share in the partnership."[86] This language may imply that special partnership allocations of installment debt will not be given effect regardless of their economic reality.

As discussed in Part II.B.2.b. above, the statutory language and the legislative history of section 453A support a "snapshot" approach to test whether the section 453A interest charge should apply at all to a particular installment obligation held by a particular taxpayer. That is, the determination is made once, in the year the obligation arises. Likewise, as discussed in Part II.B.2.a. above, the "applicable percentage" of the taxpayer's debt arising in a given year should not change in future years as the debt is paid off or as the taxpayer accumulates additional debt.[87] If the taxpayer in question owns the installment debt indirectly through an S corporation or partnership, a shift in that taxpayer's pro rata interest in the entity's assets does not cause a new obligation to "arise" in the year in which the shift occurs. Thus, there would be no basis in the statute or the legislative history for taking a new "snapshot" at that time. Instead, the applicability of the interest charge ought still to depend on the amount of installment debt that was attributable to the taxpayer in the year the debt arose, and the same applicable percentage should still govern.

What does change in such a situation, however, is the amount of unrecognized income attributable to the taxpayer. If a shareholder's interest in the obligation increases, presumably so too will the shareholder's interest liability. However, if the taxpayer did not exceed the $5 million threshold in the year the debt arose, but exceeds it in a later year because of a change in the pro rata interests of the pass-through entity's owners, then that taxpayer will still avoid the interest charge. Conversely, one or more of that taxpayer's fellow partners or shareholders may exceed the threshold in the year the note arises, then fall below the threshold as a result of a later shift in pro rata interests. Such a taxpayer will still be subject to the section 453A interest charge, but the charge will apply to the taxpayer's now-reduced share of the entity's unrecognized income attributable to the installment debt.

The impact of a change in pro rata interests may depend on the manner in which that change is effected. As amended in 1988, section 453A(e)(2) instructs the Treasury to "prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations . . . providing that the sale of an interest in a

86. *See supra* text accompanying note 59.
87. *See supra* text accompanying notes 59-60.

partnership or other pass-through entity will be treated as a sale of the proportionate share of the assets of the partnership or other entity." Since the sale of an installment obligation accelerates the tax liability that otherwise would be deferred under section 453, it would appear that the regulations authorized by section 453A(e)(2) could provide that the sale of an interest in a pass-through entity triggers the deferred gain attributable to that interest. The same principle should apply to a sale of less than all of the seller's interest in the pass-through entity; deferred gain should be recognized on a pro rata share of the underlying installment debt.

The Service has already articulated this principle in the partnership context, stating that a sale of a partnership interest triggers the selling partner's proportionate share of the partnership's deferred gain on installment debt.[88] It is likely the Service will treat section 453A(e)(2) as authority to apply this principle to S corporations as well.

For example, suppose Ms. A and Ms. B own 75% and 25%, respectively, of Corporation AB, an S corporation. Ms. A, Ms. B, and AB all report on a calendar year. In 1989, AB sold property it held at a zero basis for a $20 million installment note. Ms. A, Ms. B, and AB had no other sales reportable on the installment method during 1989. Ms. A's interest charge with respect to 1989 is $308,000 (.11 × .28 × 2/3 × $15 million) and Ms. B's interest charge is zero (because Ms. B's applicable percentage is zero). On January 1, 1990, Ms. B purchases for $5 million 25% interest in AB from Ms. A. As a result, one-third of the deferred gain allocable to Ms. A (i.e., $5 million) apparently is triggered. Ms. A's interest charge with respect to 1990 should drop to $205,333 (.11 × .28 × 2/3 × $10 million), and Ms. B's interest charge should remain at zero (because her applicable percentage remains at zero). The net result is that the shareholder who owes interest at the start ends up paying less interest to the extent the deferred gain triggered under section 453A(e)(2), and the shareholder who owes no interest at the start continues to owe no interest.

Under these circumstances, the failure to re-test is revenue neutral, but that is not always so. Consider a case in which the change in pro rata interests is not effected through a sale. Suppose, in the above example, that instead of purchasing one-third of Ms. A's interest, Ms. B increases her 25% interest in AB to 50% by contributing cash or other property to AB in exchange for additional AB stock. In that case, unless the shift in pro rata interests is treated as

88. Rev. Rul. 60-352, 1960-2 C.B. 208, 210.

a "sale" (within the meaning of section 453A(e)(2)), Ms. A will not be deemed, under that section, to have sold one-third of her interest in the installment note, and accordingly will not accelerate her tax liability on any part of the note. At the same time, Ms. A's 1989 interest charge drops from $308,000 to $205,333, just as it did in the case of the sale. Ms. B's interest charge remains at zero, because her applicable percentage remains at zero. Under this scenario, the failure to re-test results in loss of revenue to Treasury. Likewise, if AB acquires additional assets in a tax-free reorganization in which the shareholders of the acquired corporation become shareholders of AB, no gain to AB's shareholders is triggered, yet Ms. A's and Ms. B's section 453A interest charge (individually and in the aggregate) may be significantly diminished because both Ms. A and Ms. B now own smaller shares of the entity and therefore have less unrecognized gain with respect to the installment note.

In the case of a sale—or any transaction treated as a sale for purposes of section 453A(e)(2)—what happens when a shareholder's or partner's allocable share of the deferred gain is triggered? Sensibly, it would appear that, under section 453A(e)(2), the deferred gain should be deemed recognized immediately before the sale so that the seller gets the benefit of the basis increase resulting from the recognition of the gain. Thus, in the case of Ms. A above, under section 453A(e)(2), her sale to Ms. B should be viewed as if, immediately prior to such sale, AB recognized $5 million of gain (*i.e.*, the proportion of the deferred gain attributable to the sold interest), all of which is allocated to Ms. A. Thus, Ms. A's basis in her AB stock should increase by this $5 million gain allocable to her.

What happens when, in 1992, AB collects payment in full on the installment sale? About the only thing that seems clear is that AB should recognize only an additional $15 million of gain. How that gain is allocated between the shareholders, however, is unclear. One possibility is to allocate the gain on a proportionate basis in accordance with the shareholder's respective interests in AB. Thus, in our example, that means $7.5 million of the gain would be allocated to each of Ms. A and Ms. B. This would result in Ms. A recognizing gain attributable to the note totaling $12.5 million which, of course, is less than the gain she would have recognized had this not been an installment method transaction. However, carrying the example through liquidation of the entity, it becomes relatively clear that this is the correct approach. That is, under this approach Ms. A will recognize an additional $2.5 million of gain upon a distribution to her by AB of $10 million (her share of the cash payment with respect to the $20 million installment note) in complete liquidation of her AB stock and Ms. B will recognize a $2.5 million loss. Thus, in the aggregate, Ms. A will have received $15 million of cash ($10 million from AB and $5 million from Ms. B) and recognized $15 million of gain ($12.5 million from the installment note plus $2.5 million representing the excess of the cash received by Ms. A over Ms. A's $12.5 million basis increase) and Ms. B will have received $5 million of cash ($10 million from AB less $5 million paid to Ms. A) and recognized $5 million of gain ($7.5 million from the installment note less a $2.5 million loss representing the excess of $12.5 million basis over the $10 million cash received).

It remains to be seen how Treasury will react to the issues raised by a change in the shareholders' pro rata interests in an S corporation (or partnership) holding an installment obligation. Conceivably, Treasury could interpret section 453A(e)(2) to encompass all shifts in ownership interests, regardless of how effected. The validity of such a broad interpretation would be questionable. Alternatively, Treasury could promulgate regulations requiring re-testing each time there is a change in the pro rata interests of shareholders or partners. To respect the non-cumulative character of the $5 million threshold, however, the regulations would have to re-test the installment obligations according to the taxable year in which they arose. Installment obligations that arose in Year 1 would have to be placed in a separate testing "basket" from installment obligations that arose in Year 2. This approach would be burdensome, and arguably inconsistent with the intent of Congress.[89]

(ii) Before the installment sale

A different set of issues is raised when the owners of a pass-through entity take action prior to a transaction to avoid becoming subject to section 453A. This may occur, for example, when the owners have unequal interests in an entity selling assets, or when some owners engage in outside transactions in the course of which they receive additional installment obligations. Ideally, of course, the seller should negotiate to pass some or all of the section 453A interest charge on to the buyer, because the buyer is benefiting from the step-up in asset basis and from the seller's willingness to accept deferred payments instead of cash. It may be that the owners' aggregate interest charge is simply prohibitive; if so, and if it cannot be passed on to the buyer, then an installment sale may not be advantageous. However, if the benefits of installment reporting outweigh the net aggregate interest charge (*i.e.*, the aggregate interest charge

89. *See supra* notes 66-74 and accompanying text (discussing timing issues).

borne by the owners and not passed on to the buyer), then if the interest charge falls on only some of the owners, they may wish to negotiate an interest-sharing arrangement among themselves. They may decide, for example, that the party incurring the interest expense should bear the entire burden thereof, or they may find it more advantageous to divide the expense among themselves. This might be the case, for example, where a majority owner threatens to block a highly profitable sale by the entity because that owner's individual section 453A interest liability will be too high.

Although this might be a safe strategy in the case of a partnership, there is a real concern that such a shareholder agreement would violate the one-class-of-stock requirement for eligibility to be taxed as an S corporation.[90] Shareholder agreements present this problem when they cause shareholders to have different interests in the profits and assets of the corporation.[91] An agreement among an S corporation's shareholders to compensate one another for certain items of individual tax liability could be viewed as affecting their respective interests in the profits or assets of the corporation. This is another area in which the absence of authoritative guidance should cause tax planners to proceed with extreme caution.

Alternatively, it may be possible to "change the mix" of ownership interests to bring certain owners below the threshold before the contemplated sale occurs. For example, if three shareholders own 15%, 25%, and 60%, respectively, of an S corporation that expects to receive a $10 million installment note, and if none of the shareholders will acquire, during the same taxable year, other installment notes to which section 453A applies, then only the 60% shareholder will exceed the $5 million threshold. The corporation or the shareholders could take action to reduce this shareholder's interest to less than 60%. A redemption of the excess interest (assuming a redemption is not a "sale" for purposes of section 453A(e)(2)) would solve the problem but might also result in taxa-

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90. I.R.C. § 1361(b)(1)(D) (1990) (stating more than one class of "stock disqualifies small business corporation" as S corporation).

91. *See generally* S. REP. No. 640, 97th Cong., 2d Sess. 8 (1982), *construed in*, 1982-2 C.B. 718, 721; H.R. REP. No. 826, 97th Cong., 2d Sess. 8 (1986), *construed in*, 1982-2 C.B. 730, 733 (explaining one class of stock requirement for eligibility of subchapter S treatment).

Newly proposed regulations provide that a corporation has a second class of stock if (i) all shares do not have identical rights to distribution and liquidation proceeds, (ii) the corporation makes non-conforming distributions (i.e., distributions that differ with respect to timing or amount), or (iii) if it issues an "arrangement" which would be treated as stock under general principles of federal tax law. Prop. Treas. Reg. § 1.1261-1(1) (2)-(3) (1990). This language does not specifically address agreements between shareholders to shift their individual section 453A interests liabilities. The agreement discussed in the text, however, arguably confers non-identical rights to "distribution and liquidation proceeds," in violation of the one-class-of stock rule.

ble gain to the shareholder whose interest is thereby reduced. Alternatively, the shareholders with the smaller interests could make a contribution to the corporation's capital, thereby increasing their interests and lowering the percentage interest of the largest shareholder from 60% to 50% or less. In this case, no shareholder incurs a current tax and the section 453A interest charge is eliminated.

Where the taxpayer is willing to share his or her bounty with another person, a gift or bargain sale of the excess stock interest could also accomplish the desired result.[92] Similarly, the shareholder could place the excess stock interest in a qualified subchapter S trust (other than a grantor trust) benefiting such other person.[93] Such transactions are risky, however, to the extent they involve related taxpayers. Section 453A(e) authorizes the Secretary of the Treasury to prescribe regulations disallowing use of the installment method in whole or in part for transactions in which the rules of section 453A could be avoided by the use of "related persons, pass-through entities, or intermediaries."[94] How broadly the Treasury will interpret these terms—particularly the ambiguous "related persons"—remains to be seen.

Another way to shift pro rata interests is to admit a new shareholder. If the new shareholder receives full beneficial ownership in the entity—not mere legal title to an ownership interest—the shift in interests should be respected for purposes of section 453A.[95]

Using the facts from the above example, if the shift in the shareholders' interests were to occur before the start of the taxable year of sale[96] so that the shareholders would have, as a result of the shift, 20%, 30%, and 50% pro rata interests in the corporation, respectively, then no shareholder's share of the installment receivable would exceed $5 million. Provided the form of this transaction comports with economic reality, the IRS should respect the form. It would be unwise for the shareholders to return to their "15-25-60" split (*e.g.*, by stock redemptions or capital contributions) soon after

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92. A donee is not taxed on the receipt of a gift, I.R.C. § 102(a) (1990), although the donor will incur gift tax liability if the value of the gift together with any prior gifts exceeds a threshold amount. I.R.C. §§ 2501-2503 (1990).

93. *See* I.R.C. § 1361(c)(2), (d) (1990) (allowing certain qualified subchapter S trusts to be S corporation shareholders).

94. *Id.* § 453A(e)(1).

95. Rev. Rul. 78-285, 1978-2 C.B. 137 (discussing whether sale by shareholder of shares of corporation prior to liquidation enables shareholder to reduce stock ownership to qualify for non-recognition of gain or loss of its assets). *Cf.* Granite Trust Co. v. United States, 238 F.2d 670, 674 (1st Cir. 1956) (concluding corporate taxpayer's sale of stock in wholly owned subsidiary to friendly buyers after decision to liquidate subsidiary enabled corporate taxpayer to recognize loss on liquidation).

96. Ownership shifts *within* the taxable year are considered in calculating each shareholder's pro rata share of any item for the taxable year. I.R.C. § 1377(a) (1990).

the taxable year in which the corporation receives the installment note; such a quick reversal would invite the Service to disregard the temporary shift in ownership.

Similar strategies—and the accompanying risks—apply to partnerships. If special allocations of installment debt are respected for purposes of section 453A, the shift in interests could be accomplished by a change in special allocations. Otherwise, a change in the partners' overall partnership interests would be required. On the other hand, a taxpayer who has contributed an asset subject to section 704(c)[97] might be attributed an interest in the installment obligation significantly greater than the taxpayer's interest in the partnership upon a subsequent disposition of that asset on the installment method.

In short, it is likely that Treasury will make full use of its statutory authority to disallow installment reporting where taxpayers seek to avoid the section 453A interest charges "through the use of related persons, pass-through entities, or intermediaries."[98] It is less clear, however, how the Treasury will address the application of section 453A to a change in the pro rata interests of shareholders or partners that is accomplished by other means and/or is motivated primarily by non-tax considerations.

3. Pledging stock

Regardless of the extent to which the shareholders of an S corporation (or their counterparts in a partnership) succeed in avoiding (or shifting) the section 453A interest charge, as long as the selling price of the property sold under the installment method exceeds $150,000,[99] the pledging rules of section 453A(d) will apply. In other words, if the taxpayer uses the installment note in question to secure new or existing indebtedness,[100] the proceeds of the secured indebtedness will be treated as payments on the note, thus accelerating gain recognition.

In some cases, shareholders may find that they have inadvertently accelerated gain recognition on installment debt by pledging their

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97. Section 704(c) provides that income, gain, loss, and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners to take account of the variation between the property's basis and its fair market value at the time of contribution. *Id.* § 704(c).

98. *See id.* § 453A(e) (stating Treasury will prescribe regulations necessary to carry out purposes of section 453A).

99. *See supra* text accompanying note 52-53.

100. Section 6031 of TAMRA provides an exception for certain refinancings of debt already secured by the installment obligation in question. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3695 (1988).

stock in the S corporation as security for a loan. Section 453A(e)'s authorization to disallow installment reporting in circumstances where the application of section 453A could be avoided by the use of "related persons, pass-through entities, or intermediaries" could permit the IRS to "look through" a pledge of stock in an S corporation holding installment debt.[101] Thus, if a shareholder pledges stock in an S corporation as security for a loan, and if the S corporation holds an installment note subject to section 453A, the pledge of the stock could be recharacterized as a pledge of the note itself. The risk of such a recharacterization is especially great if the pledge occurs after the asset sale and if the installment note represents a substantial portion of the S corporation's post-sale assets. Conceivably, however, even a pre-existing pledge of a taxpayer's S stock could, upon receipt of an installment note by the corporation, cause the pledging shareholder to recognize immediate gain on that shareholder's pro rata share of the note.[102] Thus, if Mr. A, an S corporation shareholder, has outstanding indebtedness secured by S corporation stock, Mr. A could be unpleasantly surprised to discover that the S corporation's subsequent sale of its assets on the installment method results in immediate gain recognition by Mr. A even though Mr. A's fellow shareholders, who have not pledged their stock as security for indebtedness, enjoy the full benefits of installment reporting.

When a pass-through entity receives payments on installment debt after one owner has recognized deferred gain by pledging his or her ownership interest, a question arises as to how the remaining deferred gain is allocated among the owners. The principles of Rev. Rul. 60-352 and IRC section 453A(e)(2) suggest that the correct approach in the pledge context is the same as the approach in the sale context, as discussed above in Part II.B.2.d.i.

C. *Valuation of contingent payment obligations*

To calculate a taxpayer's section 453A interest liability on a particular installment obligation, it is necessary to know the amount of unrecognized income attributable to that obligation at the close of the taxable year. Likewise, to determine whether the $5 million threshold is exceeded, and what the taxpayer's "applicable percentage" should be, the face amount of an installment note must be ascertainable. Each of these tasks presents a problem in the case of a contingent note—*e.g.*, an "earn-out"—since the "face amount" is

101. I.R.C. § 453A(e) (1990).
102. *See id.*

not specified, and the amount of "unrecognized income," therefore, is likely to be unknown at the time the interest charge accrues.

Determining the applicability and amount of the interest charge in the case of a contingent payment obligation cannot be done with certainty under current law. The Conference Committee Report on the pertinent provisions of the Revenue Act of 1987 instructs the Secretary of the Treasury to prescribe regulations that address "the treatment of contingent payments for purposes of the $5 million threshold and for purposes of determining the amount of gain that remains to be recognized under an installment obligation as of the end of any taxable year."[103] At this time, however, the Treasury has offered no guidance on these issues. Two possible approaches are discussed below.

One approach would be to treat the amount of unrecognized gain as the gain which the taxpayer (or the reporting entity, in the case of an S corporation or partnership) would have recognized on the note had the reporting entity elected out of installment reporting.[104] In that case, the unrecognized gain would be the gain which the reporting entity would have reported under its usual method of accounting. Under this election-out approach, the amount of deferred tax (and hence the amount of the section 453A interest charge) likely would be tied to the fair market value of the obligation on the date the asset sale takes place.[105] The face amount of the obligation, for purposes of computing the applicable percentage, could be determined in the same manner.

If the election-out approach is adopted, what happens if subsequent events are inconsistent with the original valuation of the contingent note? A note might, for example, be found to have a particular fair market value on the date of sale, but subsequent payments on the note might differ from the expected payout on which that valuation was based. Thus, a note valued at less than $5 million when received (so that it does not by itself trigger the section 453A interest charge) might in fact yield payments with a present value of considerably more than $5 million. Thus, while the note did not

103. H.R. REP. No. 495, *supra* note 50, at 930.

104. I.R.C. § 453(d)(1) (1990) (permitting taxpayer to elect not to have section 453(A) apply to disposition).

105. Under this approach, a cash method taxpayer's unrecognized gain would equal the fair market value of the note, and an accrual method taxpayer's unrecognized gain, which normally is the face amount of the note, would equal or exceed the note's fair market value. Temp. Treas. Reg. § 15A.453-1(d)(2)(iii) (as amended in 1981). In "rare and extraordinary cases," in which the fair market value of the note could not reasonably be ascertained, the taxpayer could invoke the "open transaction" doctrine of *Burnet v. Logan*, and avoid recognizing any gain until payments are received in excess of the basis of the assets sold. *See infra* notes 110, 178-79 and accompanying text; *see also* Burnet v. Logan, 283 U.S. 404, 413 (1931).

trigger a section 453A interest charge when received, it would have if the appraiser had predicted the stream of payments more accurately. Under the reverse scenario, a taxpayer might incur a section 453A interest charge based on a valuation in excess of $5 million that proves to be overly optimistic. In between these two cases is the case in which the fair market value of the contingent note exceeds $5 million at the time of its receipt and would still exceed the $5 million if the future events were accurately foreseeable at that time—thus, there is no doubt that the interest charge should apply—but the applicable percentage and the amount of unrecognized income that are used to calculate the section 453A interest charge arguably would be incorrect in light of later developments. If the Treasury adopts this approach, it will have to determine whether an underpayment of the interest charge will give rise to an obligation to pay interest, and whether any refund of an overpayment would be taxable income.

A second method of quantifying the unrecognized income arising from a contingent note would parallel the method currently prescribed in the income tax regulations for calculating a seller's gross profit ratio on receipt of contingent installment payments.[106] Under this approach, the applicable percentage and amount of unrecognized income would be based on the maximum amount payable (if any) on the contingent note.[107] Compared with the election-out approach, this method usually would result in a significantly higher interest charge. Indeed, if the taxpayer paying section 453A interest on a contingent installment obligation ultimately fails to receive payments equalling the maximum amount payable on the obligation, then arguably the taxpayer would have paid too much interest. In other words, the taxpayer would have paid interest on income that was not merely deferred, indeed it was never income at all. Absent guidance from the Treasury, it is uncertain whether such a taxpayer would be entitled to a refund of the "overpaid" interest and, if so, whether the refund would be taxable income.

Whichever method the Treasury adopts, a sensible solution might be to bifurcate the analysis between, on the one hand, determining the applicable percentage and whether the $5 million threshold is exceeded and, on the other hand, computing the amount of the section 453A interest charge. For example, suppose Mr. K sells prop-

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106. *See* Temp. Treas. Reg. § 15A.453-1(b)(2) and (c) (as amended in 1981).

107. If the Service followed the "gross profit ratio" methodology exactly, it would exclude from this face amount an amount representing stated or imputed interest. *Cf.* Temp. Treas. Reg. § 5A.453-1(b)(2)(ii) (as amended in 1981) (noting that stated or imputed interest is not considered part of selling price).

erty with a zero basis for a \$3 million fixed installment note and a contingent note with a maximum payout of \$12 million, but a current fair market value of \$7 million. Resorting to the election-out approach, the Treasury reasonably could determine that for purposes of calculating Mr. K's applicable percentage and whether he had exceeded the \$5 million threshold, the contingent note must be considered, but that, in calculating the amount of the section 453A interest charge, the contingent note should not be treated as deferring gain. Under this approach, Mr. K's applicable percentage would be 50% ((3+7−5)/10), but his deferred gain would be \$3 million, not \$10 million. (Under the second approach described above, the analysis would be the same, except that Mr. K's applicable percentage would be (3+12−5)/15 or two-thirds).

Although this appears to be a pro-taxpayer result, in fact it is not. The buyer does not include in the basis of the acquired assets any portion of the contingent note (until, of course, payments are made with respect to the note).[108] Thus, one of the reasons for adopting section 453A, to offset the effect of the buyer obtaining depreciation deductions while seller defers gain recognition,[109] is not of concern when the installment note is contingent. The balanced result, therefore, is not to impose the section 453A interest charge if the buyer has not included the installment obligation in the basis of the acquired assets.

Finally, in the "rare and extraordinary" case in which a taxpayer receives a contingent obligation that is not susceptible to valuation, under either approach the taxpayer should not incur a section 453A interest charge.[110]

III. THE IMPACT OF SECTION 1374

Unlike a partnership, an S corporation selling assets is potentially subject to a corporate-level tax under section 1374.[111] Generally speaking, section 1374 as amended in 1986 imposes a corporate-level tax on gains recognized by an S corporation to the extent they

108. Temp. Treas. Reg. § 1.1060-1T (1986) (prescribing purchase price allocation rules for certain asset acquisitions).

109. JOINT COMM. ON TAXATION, 98th Cong., 2d Sess. 334, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Jt. Comm. Print 1984) (noting Congress' concern with mismatch of income and deductions).

110. *See* Temp. Treas. Reg. § 15A.453-1(d)(2)(iii) (as amended in 1981) (stating taxpayer may treat transaction as "open" only in "rare and extraordinary" circumstances in which fair market value of contingent obligation cannot reasonably be ascertained).

111. *See* I.R.C. § 1374(a) (1990) (imposing corporate-level tax on certain S corporations with "net recognized built-in gains"). As amended by the 1989 Act, section 6655 now requires S corporations to make estimated payments of corporate-level taxes, including the section 1374 tax. Pub. L. No. 239, 101st Cong., 2d Sess., § 7209(a) (1989).

are attributable to increases in the value of the corporation's assets that took place during any period(s) in which the corporation was a C corporation.[112] As discussed below, the 1986 amendments to section 1374 dramatically increased the burden of the section 1374 tax on many S corporations that might have been able to use installment sales to skirt the provisions of section 1374 under prior law.[113] In its newest incarnation, section 1374 will prevent many—if not most—C corporations from avoiding a corporate-level tax on a sale of their appreciated assets by electing S status prior to the sale. As discussed below, however, former C corporations which made their current S election before January 1, 1987 (and certain small C corporations making a later S election under a transition rule) will find it much easier to avoid this double taxation.

An S corporation which has never been a C corporation will generally not incur a tax under section 1374 (as in effect before or after the 1986 Act).[114] For such corporations, then, section 1374 is not a factor in assessing an asset sale. With respect to any S corporation that was previously a C corporation, however, the effect of section 1374 on capital gains recognized after conversion to S status depends on whether or not the corporation has in effect, at the time of the sale, an election to be taxed as an S corporation which was filed in time to be grandfathered under section 1374 as in effect prior to the 1986 amendments (hereinafter "old section 1374").

An S corporation which filed its current S election before January 1, 1987 (or, for those small C corporations qualifying under the transition rule, before January 1, 1989) is subject to the provisions of old section 1374.[115] Old section 1374 imposed a corporate-level

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112. I.R.C. § 1374 (1990).

113. *See infra* notes 115-21 and accompanying text.

114. I.R.C. § 1374(c)(1) (1990); I.R.C. § 1374(c)(1)-(2) (repealed 1986). Section 1374 will still apply, however, to capital gains attributable to assets acquired from a C corporation (or former C corporation) in a carryover basis transaction such as a section 1031 exchange or a tax-free reorganization. I.R.C. § 1374(d)(8) (1990); I.R.C. § 1374(c)(3) (repealed 1986).

115. Section 632 of the 1986 Act amended section 1374 to its current form. Tax Reform Act of 1986, Pub. L. No. 99-514, § 632, 100 Stat. 2275-77 (1986), *reprinted in* CONFERENCE COMM. TAX REFORM BILL OF 1986 (H.R. 3838), vol. 73, at I-201. Section 633 of the 1986 Act made the amendment effective only in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 633(b), 100 Stat. 2277 (1986); *id.* at I-203, 204. The Conference Committee Report confirms the result: "For S elections made before January 1, 1987, the amendments made by the conference agreement do not apply. Thus, for example, the prior version of section 1374 will apply to such corporations." H.R. REP. No. 841, 99th Cong., 2d Sess., at II-203 (1986).

Certain closely held corporations whose most recent S elections took place between January 1, 1987 and December 31, 1988 (inclusive) are not subject to the 1986 amendments to section 1374. Such corporations are instead subject to the provisions of old section 1374. The transition rule applies to a corporation if its value does not exceed $10 million and 50 percent or more of its stock is owned by ten or fewer individuals who have held the stock for five years or tax on the net capital gain (or taxable income, if lower) of an S corporation for any taxable year in which (i) the corporation's taxable income exceeded $25,000, and (ii) its net capital gain exceeded both $25,000 and 50% of its taxable income for the year.[116] The corporation's "taxable income," for this purpose, was determined independently of the shareholders' calculations of their respective taxable incomes.[117] The corporate-level tax imposed by old section 1374 was equal to the lesser of (1) the tax on the corporation's net capital gain in excess of $25,000, or (2) the tax that would be imposed on the corporation's taxable income if it were a C corporation.[118] Thus, the amount of tax imposed by old section 1374 did not depend on the extent to which the appreciation in the corporation's assets took place after the S election took effect. Any tax imposed by old section 1374 was deducted from the corporation's capital gains before they passed through and were taxed to the shareholders.[119]

Old section 1374 applied to any S corporation *except* (1) any S corporation which had an S election in effect for the corporation's three taxable years immediately preceding the year in question (including any short taxable years),[120] and (2) any S corporation which had been in existence for less than four taxable years and had never been a C corporation.[121] In effect, old section 1374 imposed a three-year waiting period on C corporation shareholders wishing to avoid a corporate-level tax on a sale of appreciated assets by converting to S status before the sale.

If old section 1374 applies to an S corporation because the corporation filed a valid S election before January 1, 1987, then, depending on the effective date of the corporation's election, and as long as that election has not terminated, the corporation will, during calendar year 1990, be at or near the date on which it is no longer subject

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longer. Full relief under the transition rule applies to a corporation if its value does not exceed $5 million, and relief is phased out for corporations with values between $5 million and $10 million. The corporation's value for this purpose is the greater of the fair market value of all of its stock as of August 1, 1986, or as of the date the S election is validly made. Tax Reform Act of 1986, Pub. L. No. 99-514, § 633(d)(8) (1986), 100 Stat. 2085, 2280; Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, § 1006(g)(7), 102 Stat. 3342, 3408 (1988); *see also* Notice 88-134, 1988-2 C.B. 559 (stating S election must be made prior to January 1, 1989 to obtain relief from *General Utilities* repeal); Rev. Rul. 86-141, 1986-2 C.B. 151.

116. I.R.C. § 1374(a) (repealed 1986).

117. *Id.* § 1374(d).

118. *Id.* § 1374(b).

119. *Id.* § 1366(f)(2).

120. *See,* Priv. Ltr. Rul. 90-23-094 (Mar. 15, 1990) (corporation electing S status before January 1, 1987 avoids section 1374 tax on asset sale taking place after three taxable years, including one short taxable year).

121. I.R.C. § 1374(c) (repealed 1986).

to the section 1374 tax.[122] An asset sale—whether for cash or a deferred payment obligation—will not trigger a corporate-level tax under old section 1374 if the sale occurs after that date.

In contrast, former C corporations that elected S status too late to be grandfathered under old section 1374 face a far more difficult hurdle in the 1986 amendments to section 1374 ("new section 1374"). Although an S corporation with no C history is still exempt from the corporate-level tax imposed by that section,[123] an S corporation with a C history now must endure a ten-year waiting period (the "recognition period") between the effective date of its S election and the date on which its capital gains can be recognized free of the section 1374 tax.[124] Unlike old section 1374, new section 1374 applies only to assets which were owned by the S corporation during its C history (or acquired from a C corporation in a carryover-basis transaction), and only to the portion of the gain attributable to appreciation in those assets that took place during that time.[125] The corporate-level tax under new section 1374 is deducted from any recognized built-in capital gain (*i.e.*, any recognized gain that represents appreciation that took place before the S election took effect)[126] which passes through to the shareholders at the end of the corporation's taxable year.[127]

In the past, S corporations subject to the tax imposed by old section 1374 could avoid that tax by selling assets on the installment method. A sale that otherwise would trigger old section 1374 could be structured as an installment sale so as to defer income recognition until after the date on which the S corporation's election had been in effect for three taxable years. Thus, if before January 1, 1987, a C corporation made an S election that was effective for the taxable year ending March 31, 1988, and the corporation sold assets before March 31, 1990 in exchange for qualifying installment debt on which no principal was payable until after March 31, 1990, the corporation would incur no section 1374 tax on the sale.[128] The

122. Corporations filing later S elections under the transition rule will, of course, have a longer wait. *See supra* note 115.

123. I.R.C. § 1374(c)(1) (1990).

124. *Id.* § 1374(d)(7).

125. *Id.* § 1374(d)(3); *see supra* note 114 and accompanying text.

126. *See* I.R.C. § 1374(d)(3) (1990).

127. *Id.* § 1366(f)(2).

128. In such a case, under current law an S corporation with subchapter C earnings and profits runs the risk of incurring a corporate-level tax under section 1375 if the interest income from the installment debt causes it to have "excess net passive income." In addition, it could run afoul of section 1362(d)(3), under which an S corporation with three consecutive taxable years of excess net passive income loses its S election. Section 1375 can be avoided (at a cost) by distributing the corporation's subchapter C earnings and profits to shareholders as a taxable dividend under section 1368(e)(3).

IRS blessed such schemes in several private letter rulings.[129] Although the Service did not explain its rationale for finding old section 1374 inapplicable to such installment payments, it may have reasoned that section 1374 applied only to income "recognized" within the three-year period, and that the installment payments in question represented income that was not "recognized" until after the period expired.

As noted earlier, when Congress repealed the *General Utilities* doctrine in 1986, it also amended section 1374 in order to discourage C corporations from converting to S status simply to avoid a corporate-level tax upon a disposition of their appreciated assets. Like its predecessor statute, new section 1374 taxes certain capital gains "recognized" within a fixed period after conversion to S status.[130] Although the "recognition" language of the new statute by itself would seem to permit the same avoidance technique that the IRS condoned under old section 1374, in amendments to section 337(d) Congress has twice expressed its intent to the contrary—ambiguously in 1986, and with greater clarity in 1988.

Section 337(d), as amended in 1986, provided, in relevant part:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to this subpart by the Tax Reform Act of 1986, including—
>
> (1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter). . . .[131]

Congress amended section 337(d) in 1988, in part to clarify that it applied not only to corporate distributions, but to conversions from C to S status as well.[132] Without specifically mentioning installment

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129. *E.g.*, Priv. Ltr. Rul. 86-49-032 (September 8, 1986) (section 1374(a) inapplicable to capital gain attributable to installment payments received after S election in effect three years, even though sale took place before end of three-year period); Priv. Ltr. Rul. 87-04-042 (October 27, 1986) (similar); Priv. Ltr. Rul. 82-43-169 (July 28, 1982) (similar, applying former section 1378, predecessor of section 1374).

130. New section 1374 taxes an S corporation's "net recognized built-in gain," defined as "any gain recognized during the recognition period on the disposition of any asset" to the extent attributable to the asset's appreciation before the corporation's S election became effective. I.R.C. § 1374(d)(3) (1990). Old section 1374, in contrast, did not distinguish between gains attributable to the pre-election period and those attributable to S years.

131. I.R.C. § 337(d)(1) (as in effect prior to amendment in 1988). Similar language appeared in the 1986 Conference Report:

> The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return provisions or the tax-free reorganization provisions of the Code . . . .

H.R. REP. No. 841, 99th Cong., 2d Sess. II-204 (1986).

132. It did so by deleting the phrase "made to this subpart by the Tax Reform Act of

sales, the 1988 Senate Report expressed concern that the provisions implementing the *General Utilities* repeal could be circumvented through use of "accounting methods" that defer corporate gain recognition, stating:

> It is . . . expected that the Treasury Department will prevent the manipulation of accounting methods or other provisions that may have the result of deferring gain recognition beyond the ten-year recognition period—for example, in the case of a C corporation with appreciated FIFO inventory that converts to S status and elects the LIFO method of accounting.[133]

On March 26, 1990, the IRS issued Notice 90-27[134] stating, among other things, that:

> [T]he purposes underlying the repeal of the *General Utilities* doctrine and the related amendments to section 1374 would fail to be carried out in certain cases if an S corporation disposes of an asset either prior to or during the recognition period in an installment sale reported under the installment method.[135]

Accordingly, the Service announced its intent to issue regulations providing that:

> [I]n certain cases, section 1374 will continue to apply to income recognized under the installment method during a taxable year ending after the expiration of the recognition period. Under the regulations, if a taxpayer sells an asset either prior to or during the recognition period and recognizes income (either during or after the recognition period) from the sale under the installment method, the income will, when recognized, be taxed under section 1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under section 453(d) not to report the income under the installment method.[136]

Under the approach announced by the Service in Notice 90-27, it will not be possible to use installment reporting to avoid the ten-year recognition period during which the section 1374 tax applies. The new regulations, which have yet to be issued, will be effective for installment sales to which new section 1374 applies, and which occur on or after March 26, 1990.[137]

1986" in section 337(d) and replacing it with "made by subtitle D of title VI of the Tax Reform Act of 1986."

133. S. REP. No. 445, 100th Cong., 2d Sess. 67 (1988).

134. 1990-15 I.R.B. 21 (April 9, 1990).

135. *Id.* at 23.

136. *Id.* (giving examples).

137. *Id.* at 23. The Joint Committee on Taxation recently recommended the repeal of section 1374. *See Daily Tax Report* (May 2, 1990), at G-7. The proposal would, it is reported, require C corporations to recognize built-in gains when they convert to S status, thus impos-

IV. AVAILABILITY OF INSTALLMENT METHOD REPORTING

Having assessed the impact, if any, of sections 453A and 1374 on the proposed installment sale, the S corporation tax planner, seeking to determine whether the benefits of an installment sale of assets will outweigh the costs, will need to determine the portion of the total purchase price that can be allocated to assets the gain from the sale of which can be reported on the installment method ("eligible assets" versus "ineligible assets"). As a preliminary matter, this requires determining which of the appreciated assets are eligible for installment method reporting and the portion of the purchase price allocable to such assets.

A. Asset Eligibility

The Code expressly disallows installment method reporting of the sale of the following types of property: (1) stock or securities which are "traded on an established securities market";[138] (2) to the extent provided in regulations, other property "of a kind regularly traded on an established market";[139] (3) personal property constituting inventory;[140] (4) generally, any other personal property if the seller "regularly sells or otherwise disposes of personal property of the same type on the installment plan";[141] (5) real property held "for sale to customers in the ordinary course of the taxpayer's trade or business";[142] (6) personal property sold under a revolving credit plan;[143] and (7) recapture income.[144] With a few exceptions,[145]

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ing a "toll charge" on the S election. *Daily Tax Report* (May 21, 1990), at G-3 to G-4. While outright repeal is unlikely, any change in the operation of section 1374 could have a significant impact on the tax analysis set forth herein.

138. I.R.C. § 453(k)(2)(A) (1990).

139. *Id.* § 453(k)(2)(B).

140. *Id.* § 453(b)(2)(B).

141. *Id.* § 453(*l*)(1)(A). Certain property used or produced in the trade or business of farming is exempt from this exclusion, *id.* § 453(*l*)(2), and certain timeshares and unimproved residential lots are exempt if the seller elects to pay an interest charge on the deferred payments, *id.* § 453(*l*)(2)(B), (3).

142. *Id.* § 453(*l*)(1)(B). The exemptions applicable to section 453(*l*)(1)(A) apply here as well.

143. *Id.* § 453(k)(1).

144. *Id.* § 453(i).

145. Although they are not the subject of an express statutory exclusion, under current law some assignments of contractual rights to receive payments for future services are apparently ineligible for installment reporting. The rationale for denying installment sale treatment for the sale of such service contracts appears to be that any resulting gain is a substitute for compensation which the seller expected to receive for providing future services; thus, it is not gain from a "disposition of property" within the meaning of section 453(b)(1). The scope of this exception is ill-defined, however, and the authorities are not entirely consistent. *Compare* Hyatt v. Commissioner, 20 T.C.M. (CCH) 1635, 1651 (1961), *aff'd*, 325 F.2d 715 (5th Cir.), *cert. denied*, 379 U.S. 832 (1964) (holding sale of reinsurance contract may not be reported on installment method) *with* Realty Loan Corp. v. Commissioner, 478 F.2d 1049, 1052 (9th Cir. 1973) (holding sale of mortgage servicing contracts may be reported on installment

other tangible and intangible property that is not the subject of a statutory exclusion—including goodwill and going concern value—is generally eligible for installment reporting.[146]

B. Purchase Price Allocation

The coincidence of selling a group of assets some of which are eligible for installment reporting and receiving consideration that

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method even though some portion of amount realized represents compensation for services). The IRS position seems to be that a sale that is a "disposition of property" for purposes of gain *recognition* under section 1001 is not necessarily a "disposition of property" for purposes of gain *deferral* under section 453. *See* I.R.C. § 1001 (1990) (providing general rules for determining amount of and recognition of gain or loss on "disposition[s] of property"). Because of the uncertainty in this arena, a taxpayer wishing to assign service contracts will need to evaluate whether the position of the Service and of the courts having jurisdiction will permit an installment sale of the particular contract rights in question. *See* Ginsburg, *Taxing the Sale for Future Payment: A Proposal for Structural Reform*, 30 TAX L. REV. 469, 504-05 (1975) (discussing problem of determining which sales qualify for installment method); *see also* Giljum, 48-6th T.M., *Installment Sales* A-28 (questioning whether substantive character of income should dictate timing of its recognition).

146. Rev. Rul. 76-483, 1976-2 C.B. 131 generally allows installment reporting of sale of partnership interest. However, gain attributable to the partnership's substantially appreciated inventory is ineligible for installment reporting. Rev. Rul. 89-108, 1989-2 C.B. 100, 101. The law is otherwise unclear regarding use of the installment method to report gain on a sale of an interest in a pass-through entity holding ineligible assets. The legislative history of section 453 implies that a taxpayer selling an interest in a partnership *or a corporation* will be unable to report the gain on the installment method to the extent it is attributable to certain publicly traded property which the taxpayer could have caused the entity to sell directly:

> The bill also provides that, under regulations to be issued by the Secretary of the Treasury (which would be effective as of the time that the provisions of the bill are effective), use of the installment method may be disallowed in whole or in part where the provisions of the bill otherwise would be avoided through use of related parties or other intermediaries. The committee intends that such regulation would apply to sales of property, a substantial portion of whose value is attributable to property gain from the sale of which could not be reported on the installment method on account of the provisions of the bill. For example, if a taxpayer sells his interest in a wholly owned corporation the only assets of which are stock or securities that are traded on an established securities market, the Secretary of the Treasury may deny the use of the installment method to account for gain on the sale.
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> The committee intends that any Treasury regulations would not deny use of the installment method if the seller could not have sold, or caused the sale of, the publicly traded stock or securities directly. For example, a retiring partner in a large investment partnership makes an installment sale of his partnership interest, a substantial portion of the value of which is attributable to stocks and securities held by the partnership. Provided that the retiring partner could not have sold or caused the sale of the partnership's assets directly, the gain on the sale of the partnership interest may be reported on the installment method.

S. REP. No. 313, 99th Cong., 2d Sess. 131 (1986). Although the Conference Committee Report does not repeat the Senate's language, it does not disavow it:

> The conference agreement provides that the Treasury Department has regulatory authority to disallow the use of the installment method in whole or in part for transactions in which the rules of the conference agreement relating to sales of publicly traded property or sales pursuant to a revolving credit plan would be avoided through the use of related parties, pass-through entities, or intermediaries. The conferees intend that these regulations are to be similar to those relating to the proportionate disallowance rule.

H.R. REP. No. 841, *supra* note 75, at II-299.

includes an installment note does not, of course, guarantee that any gain from the sale of the eligible assets may be reported on the installment method. With appropriate and documented purchase price allocations, however, the tax planner can maximize the likelihood that the IRS will respect the parties' tax treatment of the proceeds attributable to each asset included in the sale.

It is settled law that when, under a single contract, a taxpayer sells either multiple assets or a going concern under a cash-plus-deferred-payment arrangement, the sale is treated, for section 453 purposes, as a sale not of a single asset at the aggregate price, but as a sale of all the individual assets.[147] In that case, both the deferred payment and the cash downpayment must be allocated between eligible assets and ineligible assets.[148] Only the gain arising from the deferred payments allocable to eligible assets may be reported on the installment method.[149]

Before the enactment of section 1060 in 1986, taxpayers engaged in the sale of a going concern could, within certain limits, allocate the cash and deferred portions of the total selling price so as to allocate the cash predominantly to ineligible assets (including loss assets) and the deferred payments predominantly to eligible assets, thus reducing the amount of gain recognized in the year of sale.[150] The Service generally respected such allocations provided the amount allocated to each asset or category of assets reflected "relative values and arm's-length bargaining"[151] and as long as the allocations were clearly stated in the agreement of sale and were not inconsistent with other requirements of law.[152] Therefore, provided

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147. *See, e.g.*, Rev. Rul. 76-110, 1976-1 C.B. 126, 127 (stating that taxpayer cannot treat sale of several assets as "one integrated transaction" for section 453 purposes); Rev. Rul. 68-13, 1968-1 C.B. 195, 197 (explaining that sale of business must be "commuted into its fragments"); Rev. Rul. 57-434, 1957-2 C.B. 300 (adopting position that sale of "going business" is treated as sale of "individual assets comprising the business"); Priv. Ltr. Rul. 90-01-013 (Oct. 5, 1989) (stating that in sale of both eligible and ineligible property, purchase price must be allocated).

148. *See* Rev. Rul. 76-110, 1976 C.B. at 127 (explaining rationale for allocating downpayment and deferred payments ratably among assets).

149. *See id.* (ruling that in sale of three parcels, sale of one parcel at loss was ineligible for installment reporting).

150. Rev. Rul. 68-13, 1968-1 C.B. at 197.

151. *Id.*

152. *Id.* (stating that absent express allocation of purchase price by parties, IRS may allocate downpayment and deferred payments ratably among assets according to relative fair market values, or by another method if appropriate); *accord* Rev. Rul. 76-110, 1976-1 C.B. at 125; Rev. Rul. 57-434, 1957-2 C.B. 300. These authorities were published when installment sale reporting was available only for sales in which the downpayment did not exceed 30% of the selling price; thus, where a buyer paid more than 30% down, the gain from the sale of the eligible assets could be reported on the installment method only if the seller could allocate a disproportionate amount of the downpayment to ineligible assets. *See generally* Rev. Rul. 55-79, 1955-1 C.B. 370 (stating that allocating selling price according to relative values of assets

the *amounts* allocated were reasonable and properly documented, the parties could generally determine the *nature* of the consideration allocated to each asset (*e.g.*, cash or deferred payments, fixed or contingent obligations).

These allocation rules have not changed with respect to parties involved in a sale of assets that do not constitute a "trade or business" within the meaning of section 1060.[153] Where the assets sold comprise a "trade or business," however, section 1060 and the temporary regulations[154] thereunder impose new rules for the allocation of the total purchase price among the assets sold. While a detailed survey of the new purchase price allocation rules is beyond the scope of this Article, it is helpful to sketch a broad outline of the new constraints within which buyers and sellers of a trade or business must operate.[155] This summary will demonstrate that, with respect to noncontingent deferred payments equal to or exceeding the fair market value of the purchased assets, much of the pre-section 1060 allocation flexibility remains, although goodwill and going concern value must now be valued under the residual method.[156] Taxpayers allocating contingent deferred payments under similar circumstances, however, will find their freedom somewhat more limited.

Section 1060's new allocation scheme generally does not alter the requirement of prior law that purchase price allocations reflect the relative fair market values of the assets sold. However, section 1060 requires that the purchase price be allocated to the assets in a specific sequence.[157] The total purchase price must be allocated first to

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of sole proprietorship was necessary to determine extent of capital gain versus ordinary income); Monaghan v. Commissioner, 40 T.C. 680, 688 (1963), *acq.*, 1964-2 C.B. 6 (noting that where selling price of ineligible assets of sole proprietorship was separately stated, that amount was excluded from total selling price in determining whether downpayment exceeded 30%); Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945) (explaining that relative amounts of capital gain and ordinary income resulting from sale of sole proprietorship depended on particular assets sold). The 1980 Act repealed the 30% maximum downpayment rule.

153. For purposes of section 1060, a group of assets constitutes a "trade or business" if their use would constitute an active trade or business for purposes of section 355, or if the group's "character is such that goodwill or going concern value could under any circumstances attach to such group," taking into account all facts and circumstances surrounding the transaction. Temp. Treas. Reg. § 1.1060-1T(b)(2) (1986). For a discussion of the problem of determining whether a particular group of assets fits this description, see Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 TAX L. REV. 605, 611-13 (1988).

154. Temp. Treas. Reg. § 1.1060-1T (1986).

155. For a detailed survey of the new purchase price allocation rules, and an exploration of some significant grey areas therein, see Schler, *supra* note 153, at 616-23.

156. In this regard, the new rules have a greater impact on sales for less than fair market value. *See* Schler, *supra* note 153, at 619-20 (discussing valuation of goodwill and going concern value under residual method).

157. *See* Temp. Treas. Reg. § 1.1060-1T(d) (1986).

cash, demand deposits, and similar accounts in depository institutions ("Class I" assets),[158] then to certificates of deposit, United States government securities, "readily marketable" stock or securities,[159] and foreign currency ("Class II" assets),[160] thereafter to all of the remaining assets other than goodwill and going concern value ("Class III" assets),[161] and finally, to the extent of any consideration that has not yet been allocated, to the goodwill and going concern value of the enterprise ("Class IV" assets).[162]

In addition to determining the priorities of a purchase price allocation, the new allocation scheme also dictates how much consideration must be allocated to each asset.[163] The taxpayer must allocate the noncontingent portion of the purchase price dollar-for-dollar to the Class I assets first,[164] then to each of the Class II assets in proportion to their relative fair market values until each Class II asset has been allocated its fair market value,[165] and then to each of the Class III assets according to the same rule.[166] Any remaining noncontingent consideration is then allocated to the Class IV assets, to which no fair market value ceiling applies.[167] Thus, goodwill and going concern value are treated as residual assets whose value is not

158. *See id.* § 1.1060-1T(d)(1).

159. Temp. Treas. Reg. § 1.1060-1T(d)(2)(i) invokes the definition of "readily marketable stock or securities" contained in Treas. Reg. § 1.351-1(c)(3). That regulation provides: "[s]tock and securities will be considered readily marketable if (and only if) they are part of a class of stock or securities which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market." Treas. Reg. § 1.351-1(c)(3) (as amended in 1967).

However, "readily marketable" stock or securities for purposes of Temp. Treas. Reg. § 1.1060-1T(d)(2)(i) should be the same as "stock or securities that are traded on an established securities market" for purposes of determining asset eligibility under section 453(k). *See* Temp. Treas. Reg. § 15A.453-1(e)(4) (as amended in 1981) (defining "established securities market" for purposes of determining whether debt instrument constitutes payment under section 453(f)(3)-(5)).

The legislative history of section 453(k) refers to the ineligible class of stock and securities generally as "publicly traded stock or securities." S. REP. No. 313, *supra* note 146, at 131. *Cf.* Temp. Treas. Reg. § 15A.453-1(e)(4)(iv) (defining "established securities market" for purposes of determining whether a debt instrument constitutes payment under section 453(f)(3)-(5)); H.R. REP. No. 495, *supra* note 51, at 947-48.

160. *See* Temp. Treas. Reg. § 1.1060-1T(d)(2)(i) (1986).

161. *See id.* § 1.1060-1T(d)(2)(ii). A covenant not to compete is a Class III asset. *Id.* Under some circumstances, however, it may be unclear whether the party "selling" the covenant is the selling entity itself or the owners or employers thereof. In the case of an S corporation with common shareholders/employees, for example, the covenant could be viewed as a promise by the shareholders rather than the corporation. Section 1060 and the regulations offer no guidance on this point. *See* Schler, *supra* note 153, at 636-39 (suggesting possible approaches to problem).

162. Temp. Treas. Reg. § 1.1060-1T(d)(iii) (1986).

163. *See id.* § 1.1060-1T(d), (e). Consideration allocable to each class of assets, except Class IV assets, may not exceed the assets' fair market value on date of purchase. *Id.* § 1.1060-1T(e).

164. *Id.* § 1.1060-1T(d)(1).

165. *Id.* § 1.1060-1T(d)(2)(i), (e).

166. *Id.* § 1.1060-1T(d)(2)(ii), (e).

167. *Id.* § 1.1060-1T(d)(2)(iii), (e).

ascertainable independently of the value of the other assets constituting the trade or business.

If the total purchase price includes a contingent component, the temporary regulations provide the following general rule:

> (f) Subsequent adjustments to consideration — (1) In general. If there is an increase or a decrease in consideration of either the seller or the purchaser after the purchase date that must be taken into account in order to adjust or redetermine, under applicable principles of tax law, the seller's amount realized with respect to, or the purchaser's cost of, the assets transferred, then such increase or decrease is allocated by the seller or the purchaser among the assets pursuant to this paragraph (f).
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> (2) Allocation of increases in consideration — (i) In general. An increase in consideration is allocated under paragraph (d) of this section among the assets transferred. Amounts allocable to an asset (or with respect to an asset disposed of by the purchaser) are subject to the fair market value limitation and other limitations in paragraph (e) of this section. Except as provided in paragraph (f)(4)(ii) of this section, for the purpose of applying paragraph (e) of this section, the fair market value is the fair market value on the purchase date.[168]

Thus, if the aggregate amount of noncontingent consideration fails to equal or exceed the face value of the Class I assets dollar-for-dollar plus the total fair market value of the Class II and Class III assets, then a subsequent increase in consideration (*i.e.*, any contingent amount that is in fact paid) is allocated to the first asset class in this sequence which has not been allocated the maximum amount allowed. Once that class has received its full allocation, any remaining amount of the contingent consideration is allocated to the next class, and so on until the last of the contingent consideration is allocated entirely to Class IV assets.

Except for separating fixed from contingent obligations, neither section 1060 nor the temporary regulations dictate the *nature* of the consideration that may be allocated to a particular asset or class of assets. Thus, if an S corporation sells assets constituting a trade or business with a fair market value of $10 million in exchange for $5 million in cash and a $5 million three-year noncontingent note, the

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168. *Id.* § 1.1060-1T(f)(1), (2)(i). Subsequent *decreases* in consideration, in contrast, are generally deducted first from the amount previously allocated to Class IV, then from the amount allocated to each Class III asset in proportion to its fair market value, then from the Class II allocations under the same rule, but never reducing an asset's previous allocation below zero. *Id.* § 1.1060-1T(f)(3)(i). Special rules govern increases or decreases in consideration that are specifically allocable to certain contingent income assets, such as patents. *Id.* § 1.1060-1T(f)(4).

parties may minimize immediate gain recognition by allocating the cash to ineligible (or eligible but high-basis) assets and the note to eligible low-basis assets, provided the amount of consideration allocated to each asset reflects its fair market value.[169]

In contrast, if the seller receives $5 million in cash and a three-year contingent note (*e.g.*, the amount depends on the profits derived from the purchased assets during that three year period) with a maximum $5 million payout,[170] the $5 million of cash must be allocated to the assets in Classes I through IV in the amounts and the sequence required by the temporary regulations, even if some of those assets are low-basis assets that would, but for the section 1060 rules, be eligible for installment reporting.[171]

Because Classes I and II consist of ineligible assets,[172] the difference between these two examples lies in the allocations to Classes III and IV. The fixed $5 million note in the first example can be allocated to *any* eligible Class III asset(s) provided the correct amount is allocated to the asset. If the Class I and II assets in each example have an aggregate value of $1 million, then, in the first example, the seller has $4 million in cash and $5 million in fixed deferred payments to allocate to Class III assets up to the total fair market value of the assets in that class. If the total fair market value of the Class III assets is $8 million, including eligible assets with a fair market value of $4 million (and an adjusted tax basis of zero), the seller can allocate four-fifths of the fixed installment note to eligible assets, all of the cash to ineligible assets, and the remaining $1 million of installment debt to Class IV assets (goodwill and going concern value), which are eligible assets. The bottom-line result is that the seller defers gain recognition on $5 million of the purchase price.

In contrast, in the second example, after allocating $1 million of cash consideration to Classes I and II, the seller must allocate the remaining $4 million of cash across-the-board to the $8 million worth of Class III assets, pro rata according to their relative fair market values. Thus, of the $4 million in cash received at the time of the sale, $2 million must be allocated to the eligible assets and $2 million must be allocated to the ineligible assets. Similarly, the con-

169. *See* Rev. Rul. 68-13, *supra* note 147 (allocating consideration among eligible and ineligible assets). *But see* Temp. Treas. Reg. § 1.1060-1T(e)(4) (1986) (indicating IRS may challenge taxpayer's determination of fair market value of any asset).

170. For the sake of this hypothetical, assume that the contingency is not related to the profitability of assets of the type described in Temp. Treas. Reg. § 1.1060-1T(f)(4). *See supra* note 168.

171. *See supra* notes 158-62 and accompanying text.

172. For a discussion of "readily marketable stock or securities," see *supra* note 159.

tingent note also must be allocated between the eligible and ineligible assets and, thereafter, to Class IV assets. With respect to the eligible assets, half of the inherent gain must be recognized immediately, and the balance must be recognized as payments on the note are received. With respect to the ineligible assets, all of the inherent gain must be recognized immediately (*i.e.*, the portion of the note allocated to the ineligible assets constitutes payment in the year received). The remaining portion of the note ($1 million), as in the first example, is allocated to the Class IV assets, and is reportable on the installment method. The bottom-line result is that the seller can defer recognition of only $3 million of the purchase price.

These examples illustrate the simplest cases. To complicate matters slightly, consider the tax consequences if the seller in the second example elects out of installment sales treatment. In that case, the regulations provide that a seller on the cash method of accounting[173] must report as an amount realized in the year of sale the fair market value of the contingent note, and a seller on the accrual method of accounting[174] must report as an amount realized in the year of sale an amount equal to or greater than the fair market value of the note.[175] Thus, if the fair market value of the note equaled $3.5 million, the seller's amount realized for the Class III assets would be at least $7.5 million ($4 million cash plus the value of the contingent note) and the seller would calculate his gain, all of which would be recognized in the year of sale, accordingly. If the amounts received with respect to the note exceeded $3.5 million, the excess would be reportable as income when received.[176]

What happens, however, if this is the "rare and extraordinary" case involving a contingent note the fair market value of which cannot reasonably be ascertained?[177] Will the seller be entitled to assert that the transaction is "open," and therefore use cost recovery reporting (*i.e.*, full basis recovery at the front end)? The answer seems to be yes. Although the legislative history of the 1980 Act

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173. *See* Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1987) (defining cash method of accounting). Generally, under the cash method, taxpayers report income when received and expenses when paid.

174. *See* Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1987) (defining accrual method of accounting). Generally, under the accrual method, taxpayers report income when earned and expenses when incurred.

175. Temp. Treas. Reg. § 15A.453-1(d)(2)(iii) (as amended in 1981).

176. If the buyer is an individual, the seller's income would be considered ordinary. I.R.C. § 1271(b)(1)(i) (1990). If the buyer is a corporation, the additional payment would be considered an amount received in exchange for the note (generally capital gain). *Id.* § 1271(a)(1).

177. *See* Temp. Treas. Reg. § 15A.453-1(d)(2)(iii) (as amended in 1981); *see also supra* notes 104-07 and accompanying text (discussing "rare and extraordinary" cases).

reflects an intention to limit those cases in which taxpayers may use cost recovery reporting,[178] Congress undoubtedly anticipated that, in appropriate cases (*i.e.*, where the fair market value of the buyer's obligation cannot reasonably be ascertained), a contingent payment installment sale could be reported as an "open" transaction under *Burnet v. Logan*.[179] Thus, if this were that rare and extraordinary case, the seller in the above example could offset his full basis against the cash received at the time of the sale.

Moving to the next level of complexity, suppose the assets sold to the buyer in the above example include, among other things, stock traded on an established securities market,[180] and depreciable property which, when sold, will trigger significant section 1245 recapture income.[181] Taking the latter first, section 453(i), enacted in 1984, provides that in the case of any sale reportable under the installment method, any recapture income shall be recognized in the year of sale, and the balance of the gain shall be reportable under the installment method.[182] In the case of a fixed payment obligation, the statute achieves its purpose. That is, any recapture income is triggered immediately. Things seem less clear, however, if the obligation is contingent. Take first the case of a contingent obligation with an ascertainable fair market value. Although the statutory language ("shall be recognized")[183] is worded as a mandate, it seems rather harsh to require the seller to recognize recapture income when, in fact, the seller may never receive any payment on the note (and hence never recognize any gain). Given that one of the major abuses Congress sought to correct by enacting section 453(i)—preventing the buyer from obtaining depreciation deductions while the seller deferred income—is not a concern when a contingent note is involved (*i.e.*, the buyer gets no basis until payments are made on the note), the better answer is that Treasury should not require the immediate recognition of recapture income when the installment obligation is contingent.

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178. S. REP. No. 1000, 96th Cong., 2d Sess. 24 (1980). The legislative history refers to the 1980 Act as a means to "reduce substantially [t]he justification for treating transactions as 'open' and permitting the use of the cost-recovery method." *Id.*; *see also* Temp. Treas. Reg. § 15A.453-1(d)(2)(iii) (as amended in 1981) (stating that "[a]ny such [o]pen transactions will be carefully scrutinized to determine whether a sale in fact has taken place").

179. 283 U.S. 404, 413 (1931) (defining open transaction as transaction that is neither equivalent to cash nor possessing ascertainable fair market value).

180. *See supra* note 159.

181. *See* I.R.C. § 1245 (1990) (stating difference between adjusted basis of section 1245 property and lower of either recomputed basis of property or amount realized/fair market value on disposition is ordinary income). Section 1245 property includes personal property and certain other types of depreciable or amortizable property. *Id.*

182. *Id.* § 453(i)(1).

183. *Id.* § 453(i)(1)(A).

Similarly, what about the seller who, having received a contingent obligation without an ascertainable fair market value, elects out of installment sale treatment? In that case, section 453(i) apparently would not apply at all. That provision, by its terms, applies only to a sale reportable under the installment method. Thus, in this case it appears relatively clear that receipt of the contingent note does not trigger recapture income until payments are made on the note.

Next, consider sales of stock or securities which are traded on an established securities market.[184] In 1986, Congress enacted section 453(k)(2), under which sales of publicly traded stock or securities are ineligible for installment method reporting.[185] However, not only did Congress foreclose installment reporting for sales of publicly traded stock or securities, it also enacted a "forced accrual" rule. That is, in section 453(k)(2), Congress provided that all payments to be received from a sale of publicly traded stock or securities shall be treated as received in the year of the sale.[186] The term "payments to be received," as defined in section 453(f)(8), includes the fair market value of any contingent payment obligations.[187] If, as seems to be the case, this language reflects a decision by Congress that all contingent payment obligations received in connection with a sale of stock or securities will be deemed, by statute, to have an ascertainable fair market value, then, with respect to this narrow class of transactions (*i.e.*, sales of publicly traded stock or securities), Congress has barred the use of the open transaction doctrine. Although at first glance Congress' action may seem draconian, it simply reflects a judgment that when publicly traded stock or securities are exchanged for a contingent obligation in a taxable transaction, the readily ascertainable fair market value of the stock or securities will be used to establish the fair market value of the contingent note.[188]

To summarize, because the only distinction which the section 1060 rules draw among different types of consideration is the contingent/noncontingent distinction, the taxpayer selling assets still enjoys some flexibility in allocating a *fixed* installment note to eligi-

184. The meaning of "established securities market" in this context should correspond to the definition of that term in Temp. Treas. Reg. § 15A.453-1(e)(4)(iv) (as amended in 1981). *See supra* note 159.

185. I.R.C. § 453(k)(2) (1990).

186. *Id.*

187. *Id.* § 453(f)(8).

188. *See* Seas Shipping Co. v. Commissioner, 371 F.2d 528, 529 (2d Cir.), *cert. denied*, 387 U.S. 943 (1967) (upholding valuation of stock as equal to value of ships exchanged); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954) (holding that basis of property received in taxable exchange generally equals its fair market value).

ble and, preferably, low-basis assets under the authorities that predate section 1060. An S corporation that is considering accepting a substantial portion of the purchase price in the form of a *contingent* obligation, however, should ascertain whether this will force an allocation of more cash to eligible assets, thus accelerating gain recognition on those assets.

When a large portion of the selling price of assets constituting a trade or business is allocable to goodwill or going concern value, the seller may not be disadvantaged by accepting a contingent installment obligation. Thus, for example, if the total amount of cash (or cash equivalents) plus fixed deferred payments equals or exceeds the fair market value of the Class III assets, added to the face amounts of the Class I and II assets, then all of the contingent deferred payments would be allocable to Class IV assets, which generally are low- (or zero-) basis assets reportable on the installment method.[189] This is a favorable result and one that is attainable for many businesses, particularly those that are labor-intensive and/or service-oriented.

V. COMPLETE LIQUIDATION

A. Generally

As discussed in Part III, an S corporation that receives an installment obligation as consideration for a sale of its assets faces special tax planning considerations not applicable to an individual, a partnership, or a C corporation undertaking a similar exchange.[190] Thus, for example, before an S corporation accepts an installment note as full or partial consideration for a sale of its assets, the S corporation's tax planners must consider the impact, if any, of Code section 1374. Two additional provisions that may come into play as well are Code sections 1375 and 1362.

Section 1375 imposes a corporate-level tax on an S corporation's "excess net passive income" for a given taxable year.[191] Section 1375 applies to an S corporation for any taxable year in which (1) the corporation has subchapter C earnings and profits at the close of

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189. Where the seller originally acquired the goodwill in question by purchase, however, the basis of the goodwill will reflect the seller's cost, I.R.C. § 1012 (1990) (establishing basis of property generally as its cost), and may therefore be substantial.

190. *See supra* text accompanying notes 111-37.

191. I.R.C. § 1375 (1990). "Excess net passive income" generally means an amount which bears the same ratio to the net passive income for the taxable year as (i) the excess of passive investment income over 25 percent of gross receipts, bears to (ii) passive investment income. *Id.* § 1375(b)(1)(A); *see infra* note 193 (defining "passive investment income"). The tax under section 1375 reduces the passive investment income that passes through to the S corporation's shareholders. I.R.C. § 1366(f)(3) (1990).

the year, and (2) more than 25% of the corporation's gross receipts for the year consist of "passive investment income."[192] As interest is paid on an installment note (or deemed to be paid, in the case of imputed interest), receipt of the interest payments will cause the S corporation to have "passive investment income" within the meaning of section 1375.[193]

Worse still, if an S corporation receives passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, and has subchapter C earnings and profits at the end of each such year, its S election will terminate effective on the first day of the next taxable year.[194] Thus, if an S corporation does not have a significant amount of gross receipts other than passive investment income in a given taxable year, it risks both an annual corporate-level tax and, if the situation continues, a loss of its S status.

An S corporation with no subchapter C earnings and profits will not incur a section 1375 tax on its excess passive investment income, nor will an S corporation that purges itself of such earnings and profits before year-end by electing under section 1368(e)(3) to distribute these earnings and profits as a taxable dividend.[195] Either scenario will enable the S corporation to avoid termination of its S election under section 1362 as well. For the S corporation with substantial subchapter C earnings and profits, however, the tax cost of purging those earnings and profits may outweigh the benefits of installment reporting. If that is the case, then the corporation's best alternative may be to liquidate. As will be seen, the Code provisions which govern the distribution of installment obligations by an S corporation in a complete liquidation are intended to permit the S corporation's shareholders to receive the distributed obligations (although not the payments thereon) tax-free.[196] The Code provisions enacted to effectuate this result, however, are less than fully successful.

Under the general rules applicable to distributions of property in complete liquidation by C or S corporations, property received by shareholders is treated as payment in exchange for their stock.[197] In certain types of complete liquidations described in section 453(h)(1), shareholders recognize gain from the distribution of an

192. I.R.C. § 1375(a)(1), (2) (1990).

193. I.R.C. §§ 1375(b)(3), 1362(d)(3)(D) (1990). "Passive investment income" generally includes gross receipts from rents, royalties, dividends, interest (except on notes from inventory sales) and annuities, and gains from sales or exchanges of stock or securities. *Id.*

194. *Id.* § 1362(d)(3)(A).

195. *See supra* note 128.

196. *See infra* notes 200-05 and accompanying text.

197. I.R.C. § 331(a) (1990).

installment obligation not upon receipt of the obligation itself but only upon receipt of payments thereon.[198]

To avail itself of section 453(h)(1) treatment, a liquidating distribution must satisfy three important statutory requirements: (1) the liquidation must be complete; (2) the distribution must take place within twelve months of the date on which the plan of complete liquidation is adopted; and (3) the plan must be adopted before the closing date of the asset sale that gives rise to the installment obligations.[199]

In 1988, Congress enacted section 453B(h)[200] to eliminate corporate-level gain recognition on distributions by C and S corporations of installment notes to which the nonrecognition rule of section 453(h)(1) applies. In distributions to which section 453B(h) applies, an S corporation now recognizes gain or loss only for purposes of taxes imposed by subchapter S (*e.g.*, section 1374).[201]

When sections 453(h)(1) and 453B(h) apply to a distribution, the shareholder's stock basis replaces the corporation's asset basis in computing the gain recognized on each deferred payment. The character of the gain, as either capital gain or ordinary income, passes through as well.[202]

Despite section 453B(h)'s apparent promise of a tax-free distribution, section 453(h) will still accelerate gain recognition by the shareholders of an S corporation in a liquidating distribution that includes both installment debt and other property.[203] This unfortunate result, and a way to avoid it, is summarized briefly below.

A distribution of installment debt under section 453B(h) will avoid gain recognition (except for purposes of section 1374 and any other tax imposed under subchapter S of the Code) by the S corporation only if the distribution is one to which section 453(h)(1) applies—*i.e.*, a twelve-month complete liquidation treated as a sale or exchange of stock under section 331.[204] The purpose of section 453B(h) appears to be to place S corporation shareholders in the same position *after* a complete liquidation that they would occupy if the corporation itself collected payments on the installment debt and distributed such collections to its shareholders. Apparently,

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198. *Id.* § 453(h)(1)(A).
199. *Id.*
200. *Id.* § 453B(h).
201. *Id.*
202. *Id.*
203. *See* II M. Ginsburg & J. Levin, Mergers, Acquisitions and Leveraged Buyouts, Tax Transactions Libr. (CCH) ¶ 1108.03 (1989) (noting and illustrating this phenomenon).
204. I.R.C. § 453(h)(1)(A) (1990); *see also id.* § 331 (stating distributions to shareholders in complete liquidations treated as full payment for stock).

Congress believed that the corporate-level gain recognition mandated by section 336 (and section 1363(d) before its repeal by TAMRA) should not apply to distributions of installment obligations in complete liquidation of an S corporation.[205]

Even after this change in the law, however, a distribution of installment obligations by an S corporation in complete liquidation still creates discontinuities. If the S corporation distributed cash to its shareholders without liquidating, then under section 1368 the shareholders, generally speaking, would recover their stock basis before recognizing gain on the distribution.[206] The corporation could then hold the installment note and recognize gain as payments were made. In contrast, in a liquidation under section 453(h)(1), the shareholders must allocate their stock basis among all the property distributed.[207] Thus, a distribution of installment debt draws stock basis away from other items of distributed property such as cash, tangible assets, and marketable stock and securities. Lowering the basis allocated to these items means the shareholder recognizes greater gain on receipt of those items in the complete liquidation. Proposed regulations predating section 453B(h) implied that the allocation of stock basis between cash and qualifying installment obligations should reflect the full face amount of the installment debt (less any imputed interest) rather than its fair market value.[208]

For example, assume Mr. A has stock basis of $2 million in B, an S corporation with $4 million in cash and a $6 million installment note. A distribution of the cash in year 1 yields an immediate taxable gain of $2 million. Income from the installment debt still held by the S corporation passes through later as payments are received. If Mr. B instead adopts a plan of complete liquidation to which sections 453(h) and 453B(h) apply, and distributes all of the S corporation's assets to A pursuant to this plan, then only 40% of Mr. A's stock basis is attributed to the cash, and the remaining 60% is attributed to the installment debt. Accordingly, Mr. A recognizes immediate taxable gain of $3.2 million ($4 million less the product of

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205. *Compare* I.R.C. § 453B(h) (1990) (stating general rule of nonrecognition where S corporation distributes installment obligations in certain complete liquidations) *with id.* § 336 (stating general rule of corporate-level gain recognition in distributions of property in complete liquidation).

206. *See id.* § 1368(b), (c) (excluding from shareholder income corporate distributions of property up to adjusted stock basis).

207. *See id.* § 453(h)(1) (requiring receipt of payments under qualifying liquidations to be treated as receipt of payment for stock surrendered); *see also* Prop. Treas. Reg. § 1.453-2(a)(2), 49 Fed. Reg. 1742 (1984) (treating amounts distributed incident to liquidation as selling price for shareholder's stock) (withdrawn).

208. *See* Prop. Treas. Reg. § 1.453-2(e)(3), (f)(2), 49 Fed. Reg. 1742 (1984) (withdrawn).

40% multiplied by $2 million) on the distribution, $1.2 million more than in the cash-only distribution.

If the installment debt is contingent, the basis-attraction problem is exacerbated by the risk that the Service may allocate stock basis to the installment obligation based on the maximum amount payable on the obligation.[209] Thus, the amount of gain recognized in the distribution could be substantially overstated.

Until this quirk in the Code is changed, S corporation shareholders must weigh this possible cost against any section 1375 tax (and any risk of losing its S election under section 1362) that may be incurred if the S corporation has excess net passive income as a result of holding the installment obligation.[210] If section 1375 or 1362 is implicated then completely liquidating may be the better alternative. If so, the plan of sale and complete liquidation should not be adopted until after the corporation has distributed the corporation's cash or other property (other than installment debt) in a section 1368 distribution, rather than a liquidating distribution.[211] Because section 1368 generally allows basis recovery first, the shareholders will, in most cases, receive this property tax-free up to their stock basis. The corporation can then adopt a plan of sale and complete liquidation and distribute the installment debt received from the buyer pursuant to sections 453(h) and 453B(h). If, before the sale, the corporation lacks cash equal to the shareholders' stock basis, it can borrow the funds for the section 1368 distribution and then repay the loan after the asset sale from the cash portion of the consideration.[212]

As noted earlier, under old section 1374 a liquidating distribution of installment debt triggered the section 1374 tax if the distribution occurred within the three-year recognition period following conversion to S status. Thus, while a liquidation might avoid the unfavorable consequences of sections 1375 and 1362, it prevented a corporation from escaping the impact of old section 1374 when that

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209. *See* Temp. Treas. Reg. § 15A.453-1(c)(2) (as amended in 1981) (stating maximum selling price is determined by "assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement").

210. *See supra* text accompanying notes 191-94.

211. *See* I.R.C. § 1368 (1990) (outlining tax treatment of non-liquidating distributions by S corporations). Generally, in a section 1368 distribution, no gain is recognized up to the amount of the shareholder's adjusted stock basis. *Id.* If the liquidation plan is adopted before the cash distribution, the cash distribution will become part of the liquidating distribution and will therefore be offset by only part of the shareholders' stock basis. This will be true even if the cash distribution and installment note distribution take place in different taxable years of the shareholders. *Id.*

212. This plan is proposed and discussed in greater detail in Ginsburg, *supra* note 203.

section was otherwise applicable. In contrast, the applicability of the section 1374 tax will not be affected by a liquidating distribution within the ten-year recognition period, because under new section 1374 and the anticipated regulations, the section 1374 tax will apply as if the taxpayer elected out of installment method reporting.

B. *Disproportionate Liquidating Distribution of Installment Debt*

When an S corporation distributes several different types of property to its shareholders in a complete liquidation, the state corporate law governing the distribution may, together with any shareholder agreements, dictate how particular types of property should be allocated. Alternatively, these sources may be silent on the question. It may be possible, then, for the S corporation to distribute items of corporate property to its shareholders in a way that is not pro rata as to each item. For example, where one shareholder has a pressing need for cash, it may be possible as a matter of state corporate law to distribute a disproportionate amount of cash to that shareholder and a compensating disproportionate amount of non-cash property to another shareholder. In a complete liquidation to which sections 453(h) and 453B(h) apply, such an arrangement could help a shareholder to avoid accelerating gain recognition by disposing of, or pledging, his share of an installment obligation in a subsequent transaction. With appropriate planning, a disproportionate amount of installment debt can be diverted to the shareholder who can afford to retain the note and collect the payments thereon. There is authority suggesting that if such a disproportionate distribution is consistent with applicable corporate law and the contractual rights of the shareholders, the Service should respect the distribution for federal income tax purposes as well; if so, the disproportionate distribution should not be re-characterized as a pro rata distribution followed by a taxable exchange among the shareholders.[213]

213. *See* Rev. Rul. 83-61, 1983-1 C.B. 78, 79; *see also* Priv. Ltr. Rul. 84-32-036 (May 4, 1984) (disregarding fact that each C corporation shareholder did not receive pro rata interest in each distributed asset), *cf.* Rev. Rul. 69-486, 1969-2 C.B. 159, 159 (treating non-pro rata distribution of trust proceeds by agreement of beneficiaries as taxable exchange where local law did not authorize trustee to make non-pro rata distribution). Rev. Rul. 83-61, *supra*, distinguishes Rev. Rul. 69-486 on the ground that the trust beneficiaries there "were viewed as having an absolute right to a ratable in-kind distribution," whereas in Rev. Rul. 83-61 the applicable state corporate law did not give the shareholders "an absolute right to receive a ratable share of each asset distributed in liquidations." Rev. Rul. 83-61, 1983-1 C.B. 78, 79. The former proposed regulations under section 453 also supported this position. *See* Prop. Treas. Reg. § 1.453-2(f)(2) example 3, 49 Fed. Reg. 1742 (1984) (withdrawn) (describing publicly traded corporation's complete liquidation in which some shareholders receive cash only, and other shareholders receive cash and installment obligations). If the IRS did not respect the disproportionate distribution, it could re-characterize the distribution as a pro rata

Newly proposed regulations interpret the one-class-of-stock requirement of section 1361 to require that all shares confer "identical rights to distribution and liquidation proceeds," without specifying whether the rights must be identical only as to value, or as to the nature of the proceeds as well.[214] In light of this ambiguity, S corporations should seek further guidance from the Service before making distributions that are pro rata in the aggregate but disproportionate as to individual assets.

A disproportionate distribution in the context of a section 453B(h) liquidation could cause the shareholders receiving the larger shares of installment debt to receive more than $5 million of debt in one taxable year. As discussed in Part II, receipt of more than $5 million in installment debt arising from property dispositions within one taxable year generally triggers the interest charge imposed by section 453A.[215] Thus, the question arises whether a shareholder who did not cross the $5 million threshold in the taxable year of the asset sale could be deemed to cross the threshold—and incur the interest liability—as a result of a disproportionate section 453B(h) distribution. Conversely, a shareholder who *did* incur the section 453A interest charge in the year of sale might later hold less than $5 million of installment debt if that shareholder is on the "short end" of a disproportionate section 453B(h) distribution of the debt. Finally, between these extremes are those shareholders to whom the interest charge applied initially, and to whom it still continues to apply, but whose "applicable percentage"[216] would be found to have increased or decreased if it were re-tested after the disproportionate distribution. Thus, the question discussed in Part II, involving the impact of changes in the proportionate interests of the owners of a pass-through entity, becomes highly relevant in the event of a disproportionate liquidating distribution under section 453B(h). For the reasons discussed in Part II, based on the language of the statute and the legislative history, the better answer to this dilemma seems to be that the shareholders who were tested

distribution of each asset followed by a swap among the shareholders. If such a deemed exchange were found to occur, then the shareholders would be taxed as though one shareholder had sold or exchanged his or her share of the installment debt for other assets; this would cause such a shareholder immediately to recognize the gain that otherwise would be deferred through installment method reporting. *Compare* I.R.C. § 453(h) (1990) (receipt of installment obligation by shareholder in certain complete liquidation is not treated as receipt of payment for stock; instead, shareholder is deemed to receive payment for stock as payment is received on the obligation) *with id.* § 453B(a) (disposition of installment obligation triggers gain recognition).

214. Prop. Treas. Reg. § 1361-1(l)(2)-(3) (1990).

215. *See supra* notes 43-49 and accompanying text.

216. *See supra* notes 47-48 and accompanying text.

once for the applicability of section 453A to a particular installment obligation should not be re-tested after a disproportionate distribution of the obligations.[217] Because each shareholder's share of the unrecognized income represented by the installment debt will change to reflect the shareholder's ownership of a larger or smaller piece of the obligation, the shareholder receiving a larger piece will incur a greater interest liability, and the shareholder receiving a smaller piece will have a reduced interest liability, without any change in their "applicable percentages."

This approach can lead to odd results. Suppose Mr. A and Mr. B are equal shareholders in a calendar-year S corporation. Mr. A contributes zero-basis property to the corporation in return for his half interest; Mr. B contributes $20 million in cash for his half interest. Thereafter, the corporation sells the zero-basis property, receiving a $20 million installment note. Half of the installment debt is attributed to each shareholder for section 453A purposes. Each shareholder therefore has an applicable percentage of 50%,[218] and unrecognized gain of $10 million. Assuming a 28% individual tax rate and an underpayment rate of 11%, their individual interest liabilities would therefore be (.50)($10 million)(.28)(.11) or $154,000

217. *See supra* notes 59-100 and accompanying text. I.R.C. section 453(h)(1)(A), and sections 1.453-2(a) and (f) of the former proposed income tax regulations indicate that a liquidating distribution under section 453(h) should be treated as the selling price of a shareholder's stock, "as if the obligation had been received by the shareholder in an installment sale of shares directly to the person issuing the installment obligation." *See* Prop. Treas. Reg. § 1.453-2(f)(1), 49 Fed. Reg. 1742 (1984) (withdrawn). This suggests that the test of whether section 453A applies should be applied on two separate occasions: once when the S corporation receives the installment obligation and again when the shareholder receives it in a liquidating distribution. This approach, however, would permit tax avoidance in a number of situations, such as where a shareholder of an S corporation receives $150,000 or less from the liquidating corporation in exchange for the shareholder's stock, but the corporation received more than $150,000 from the sale of its assets prior to the distribution. *See* I.R.C. § 453A(b)(1) (1990) (stating section 453A applies to "any obligation which arises from the disposition of any property under the installment method, but only if the sales price of such property exceeds $150,000"). Conversely, an unfair result would follow if an S corporation sold farming property (or other property exempt from the interest and pledging rules of section 453A) in return for an installment obligation and then distributed the obligation to its shareholders in a distribution qualifying under section 453(h)(1). *Id.* In that case, the installment obligation would be exempt from the interest and pledging rules at the corporate level but not the shareholder level. A similar situation would arise where the asset sale was exempted by the effective date provision governing new section 453A but the deemed stock sale occurred after new section 453A takes effect. *See generally* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5076(c)(1), 102 Stat. 3342, 3683 (198d8) (with some exceptions, new section 453A applies to sales after December 31, 1988). All of these problems could be resolved in a logical and consistent way if the applicability of section 453A to a particular obligation were determined only at the corporate level. The authors understand that the Service has acknowledged that this is the better approach, but does not plan to offer published guidance on the question.

218. As one half of the $20 million is attributable to each shareholder, each of Mr. A and Mr. B calculates his "applicable percentage" as the difference between $10 million and the $5 million threshold, divided by $10 million.

each. Now suppose, in the following taxable year, Mr. A receives the entire installment note in a section 453B(h) liquidation, and Mr. B receives the cash equivalent. Mr. B now owes no section 453A interest because he has no unrecognized gain. Assuming that the "snapshot" approach is correct, so that Mr. A's applicable percentage remains at 50% after the distribution, he now owes annual interest of (.50)(20)(.28)(.11) or $308,000, exactly what the two shareholders would have owed in the aggregate if they had not liquidated. However, if Mr. A and Mr. B each receive half of the note and $10 million cash, Mr. A recognizes immediately $10 million of income and Mr. B recognizes none (because of his $20 million stock basis). In contrast, if Mr. A receives the entire note and Mr. B receives all the cash, neither Mr. A nor Mr. B recognizes any gain immediately (again because of Mr. B's high stock basis). Thus, a disproportionate distribution under section 453B(h) can be used to defer a greater amount of gain without increasing the section 453A interest charge.

Compare these consequences with the results of a disproportionate section 453B(h) distribution that occurs in the same taxable year (of the entity) as the asset sale itself. Using the facts in the above example, before any distribution occurs Mr. A indirectly holds $10 million of the installment debt, and Mr. B indirectly holds $10 million. If they hold these interests at the end of the calendar year, then each is subject to $154,000 in section 453A interest charges. However, if, in a section 453B(h) liquidation on or before December 31, the corporation distributes all of the installment debt to Mr. A, and cash to Mr. B, then Mr. A holds the entire note at the time the "snapshot" is taken. Instead of owing $308,000 in interest, however, he owes $462,000, because his applicable percentage is now 75% instead of 50% (*i.e.* 20-5/20). This is the same result as if Mr. A had sold the same zero-basis asset directly rather than through the corporation. By liquidating the corporation after year-end in the previous example, Mr. A achieves a tax saving that is unavailable if the liquidation occurs in the year in which the "snapshot" is taken. Conversely, of course, if Mr. A and Mr. B had been unequal shareholders, a section 453B(h) distribution of the installment debt before year-end that gave each a 50% share of the note would have reduced their aggregate section 453A interest charge.

To avoid these results, which Treasury undoubtedly will view with great distaste, the IRS could, as noted in Part II above, seek to interpret section 453A(e)(2) to authorize regulations treating transactions of this sort as "sales" (within the meaning of section 453A(e)(2)) that would trigger all or a portion of the deferred gain attributable to the interest sold. In the case of Mr. A and Mr. B above, for example, the IRS could assert that the disproportionate distribution is a "sale" which triggers immediate recognition of half of the deferred gain.

These discontinuities should also be of interest to partnership tax planners, although in the partnership context disproportionate distributions of partnership assets can raise additional considerations.[219]

VI. CONCLUSION AND A NOTE ON RATE SHIFT

The asset sale continues to be, by and large, the preferred method for winding up the affairs of an S corporation. While the TAMRA amendments to section 453A have diminished the attractiveness of installment method reporting for certain taxpayers, an installment sale nevertheless may be necessary in cases where the buyer has insufficient cash or borrowing power for an all-cash sale. In such cases, the application of section 453A to an S corporation may be significantly less costly than the application of that section to a C corporation with comparable ownership. The tax planner seeking to take advantage of this difference must be prepared to cope with the ambiguities of section 453A, to assess the risks and potential costs of sections 1362, 1374, and 1375, where applicable, and to consider, before the sale takes place, the impact on the shareholders of a complete liquidation after the sale is completed.

Because of the relatively low individual tax rates currently in effect, shareholders of S corporations (and other taxpayers) contemplating installment sales in the near future should bear in mind the risk that marginal tax rates may increase substantially at some point during the term of the installment debt. While it is unlikely that a buyer would indemnify against such a risk, a seller may be able to negotiate a right to accelerate some or all remaining payments once a tax rate increase becomes imminent. Any such option to accelerate, however, should not give the seller a unilateral, noncontingent right to accelerate all payments into the same taxable year in which the sale occurs; that right, even if never exercised, could disqualify the debt from installment reporting under section 453(b)(1). In addition, the option to accelerate should not be structured so that the obligation would be treated as "payable on demand" under applica-

219. *See* I.R.C. § 751 (1990) (treating amount of money, or fair market value of property, received by partner in exchange for all or part of recipient's partnership interest, if attributable to either "unrealized receivables of the partnership" or appreciated inventory items, as amount realized from sale or exchange of property other than capital asset); *id.* § 736 (treating certain payments to retiring or deceased partner as distributive share).

ble state or local law; an obligation of that sort does not qualify for installment reporting.[220] Even where a right to accelerate is not included in the parties' agreement, the seller facing a rate increase may still take advantage of the rules of sections 453A and 453B under which pledges and dispositions of installment debt accelerate recognition of gain thereon.

If individual tax rates increase substantially in the near future, an installment sale in a high tax year may enable the seller to take advantage of any *decrease* in effective rates (on capital gains or ordinary income) which applies to subsequent years. Until any anticipated rate decrease becomes sufficiently certain, taxpayers should evaluate the costs and benefits of installment reporting based on an assumption of stable rates. If a decrease appears imminent, however, the benefit obtained from an installment sale—having gain taxed at a lower rate—in many cases will outweigh the section 453A interest charge.

220. *See* Temp. Treas. Reg. § 15A.453-1(e)(3) (as amended in 1981) (defining "payable on demand"). For an illustration of how the "payable on demand" rule may be manipulated, see Priv. Ltr. Rul. 88-24-044 (Mar. 22, 1988) (allowing installment reporting where noteholder had option, after one year elapsed, to require full or partial prepayment subject to notice requirement and penalty of one month's interest); *see also* Priv. Ltr. Rul. 83-37-095 (June 17, 1983) (similar).

The importance of local law in determining whether an unfettered right to accelerate payment makes a note "payable on demand" is illustrated in Applegate v. Commissioner, 94 T.C. No. 42 (May 16, 1990), a recent Tax Court decision interpreting Illinois law to hold that a note subject to acceleration at the seller's option without penalty was not payable on demand and therefore qualified for installment reporting.