February 28, 2001

Installment Method Reinstated for Accrual-Method Taxpayers

By: Ronald A. Morris and Ezra Dyckman

On December 28, 2000, President Clinton signed into law legislation reinstating the installment method of accounting for accrual-method taxpayers. The installment sale provisions of the Code allow a seller to defer the imposition of tax on a sale of property until payments are actually received. These provisions are frequently used by sellers of real estate and small businesses, since in both cases buyers often require seller financing. The new legislation retroactively repeals a law that President Clinton signed just over a year earlier (December 17, 1999), which denied installment sale treatment to taxpayers whose overall method of accounting is the accrual method.

The Internal Revenue Code and Treasury Regulations generally require use of the accrual method by (1) any C corporation the average annual gross receipts of which exceed $5,000,000, except for certain personal service corporations (*i.e.*, health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting) and certain farming businesses and (2) any other business, regardless of its size, in which it is necessary to use inventory accounting to accurately determine income. Thus, under the 1999 Act such taxpayers, as well as any other taxpayer that used the accrual method of accounting, were prohibited from using the installment method for any sale of property.

In certain cases, taxpayers employ the installment method as a means of deferring taxable gain; however, in any transaction where seller financing is a necessary component, without installment method treatment the seller could owe tax prior to receipt of the cash proceeds necessary to pay the tax. As a result, various groups lobbied heavily for repeal of the 1999 Act claiming that many sellers would have to take out loans just to pay their tax liabilities. Moreover, the 1999 Act was seen as a legislative change which primarily hurt small businesses, since seller financing is more common in smaller transactions.

The reinstatement of the installment method for accrual-method taxpayers will have effects beyond those situations in which transactions are intentionally structured as installment sales. For example, the reinstatement will also affect "failed" like-kind exchanges intended to be tax-free under Internal Revenue Code section 1031. In the context of a "deferred" tax-free exchange, section 1031 requires that the taxpayer identify replacement property within 45 days after transferring the relinquished property and receive the replacement property before the earlier of (i) 180 days after the transfer of the relinquished property and (ii) the due date of the taxpayer's return for the year of the transfer. If the taxpayer is unable either to identify or to acquire an appropriate replacement property within the required time periods, the taxpayer may then receive the cash proceeds of the disposition. Treasury Regulations under section 1031 have provided that such a "failed" section 1031 exchange may generally be treated as an installment sale, so that, if cash proceeds are received in a taxable year after the year in which the taxpayer disposes of the relinquished property, the gain may be reported in the later year. Under the 1999 Act, however, if the taxpayer employed the accrual method as its overall method of accounting, the taxable income from a "failed" exchange would have been recognized in the year of disposition.

There are other circumstances in which the installment method has served as a fallback to the possible inapplicability of provisions that would make a transaction wholly tax-free. An example of such a situation is a modification of particular terms of a debt instrument held by the taxpayer. A "significant modification" (as defined in the regulations) of a debt instrument is treated as a taxable exchange of the old instrument for the new instrument. A taxpayer may take the position that a modification is not a significant modification and thus is not a taxable event. If it is later determined that the modification was significant, installment sale treatment might be available to protect the taxpayer from being required to recognize noncash income in the year of the modification.

A similar issue may arise in connection with a transfer of property to a partnership that is related to a subsequent distribution of cash to the transferor. If the transfer is treated as a "disguised sale" for income tax purposes the taxpayer might qualify for installment sale treatment, with the effect that the gain would be recognized in the year in which the taxpayer received cash consideration, rather than in the year in which the taxpayer's property was transferred to the partnership.

A more involved yet important ramification of the repeal of the 1999 Act relates to like-kind exchanges in the partnership context. An exchange of a partnership interest does not qualify for tax-free treatment as a like-kind exchange. This rule does not prevent a partnership from entering into a like-kind exchange; however, where, for example, some partners desire a continuing real estate investment and others want cash, a partnership-level exchange does not produce the desired result. Moreover, a variety of technical tax principles make it difficult to successfully structure around this problem. One solution to this problem makes special use of the installment method in conjunction with a like-kind exchange. A detailed explanation of that technique is beyond the scope of this article. It is sufficient to note that reinstatement of the installment method retains that particular tax-planning technique in the repertoire of the sophisticated tax planner.

While the benefits of the installment method for real estate owners are many and its reinstatement for accrual-method taxpayers important, taxpayers should be aware that even prior to the 1999 repeal of the installment method, there had been a number of significant limitations on use of the installment method. For example, the installment method may not be used to report gain on the sale of personal property of a kind which is required to be included in the taxpayer's inventory, of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business (subject to a limited exception for certain timeshares and residential lots), or of stock or securities which are traded on an established securities market; nor may it be used to defer income from "depreciation recapture." Moreover, even when use of the installment method is available, the seller may be subject to an interest charge on a portion of the tax liability that is being deferred by the use of that method; this interest charge generally applies only if the face amount of all installment obligations held by a taxpayer that arose during a particular year and are outstanding at the close of such year exceeds $5,000,000.

The effective date provision of the new Act provides that, for purposes of applying the Internal Revenue Code, it shall be as if the 1999 amendment (which was effective as of December 17, 1999) were never made. All 2000 transactions will therefore be entitled to installment sale treatment, if they otherwise qualify. For most taxpayers, returns for the 2000 year will be due on April 16, 2001, presenting no procedural barriers to proper filing. But for taxpayers who have already filed (including those who filed for 1999 or for a fiscal year ending in 2000), certain technical problems could bar the filing of an amended return. The installment method does not apply to any disposition for which a taxpayer elects out of the installment method. A taxpayer elects out of the installment method when he or she files a tax return reporting the full selling price as the amount realized with respect to an installment sale. An election out of the installment method may be revoked only with the consent of the Secretary of the Treasury.

A taxpayer who sold property in an installment sale on or after December 17, 1999 may have already filed a return showing an amount realized equal to the entire selling price. Such a taxpayer may have inadvertently elected out of the installment method and, as a result, may not be able to benefit from the repeal of the 1999 Act. Just last week, however, the Internal Revenue Service released Notice 2001-22, which cures this technical problem. Notice 2001-22 provides that an accrual method taxpayer who entered into an installment sale on or after December 17, 1999 and filed an income tax return by April 16, 2001, has the consent of the Secretary of the Treasury to revoke the election out of the installment method, provided the taxpayer files an amended Federal income tax return before the statute of limitations runs with respect to the taxable year in which the installment sale occurred.

Notice 2001-22 is a welcome response by the IRS to a technical problem that could have created confusion if it had not been addressed in so prompt a fashion.
