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Sales and Exchanges of Capital Assets for Deferred Payment Obligations

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SALES AND EXCHANGES OF CAPITAL ASSETS FOR DEFERRED PAYMENT OBLIGATIONS

Receipt of deferred payment obligations precipitates ordinary closed transaction treatment unless the taxpayer elects the installment method under section 453. In cases where the obligation is held not to be the equivalent of cash, a taxpayer may qualify for open transaction treatment. The author considers the theoretical underpinnings of these three treatments as well as their actual cost to the taxpayer. She concludes that section 453 provides an equitable method of taxation, while the extension of open transaction treatment is inappropriate beyond the strict terms of the cash equivalency and no ascertainable fair market value tests.

I. INTRODUCTION

When a taxpayer receives a deferred payment obligation from a noncorporate debtor in return for the sale or exchange of a capital asset, important and serious questions are raised concerning the treatment of such a transaction under the current tax law. Closed transaction treatment may be impractical or undesirable for a variety of reasons, including difficulties in determining the fair market value of the obligations and the burden of paying an immediate tax on gain that will be realized only over a period of years. One alternative that mitigates the problems is the installment payment mechanism under section 453 of the Internal Revenue Code, although to elect this alternative, the taxpayer must fulfill the conditions of eligibility required in the Code. Another possible method of dealing with deferred payment obligation transactions is open transaction treatment, but it is accompanied by its own stringent requirements; the taxpayer must satisfy either the no ascertainable fair market value or cash equivalency tests.

The following analysis will examine each method of treatment as it applies to transactions involving deferred payment obligations. These methods of treatment will then be considered in light of how closely they approach, within the confines of the tax law, what would be ideal tax treatment of the transaction.

1. This Note deals with those obligations which will produce ordinary income when gain is realized on their retention and collection. See, e.g., Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962). Internal Revenue Code of 1954, section 1232(a)(1) deems corporate and governmental obligations to be collected "in exchange therefor." By deeming retention and collection of those obligations to be exchanges, the gain on the obligations is taxed as capital gain under Internal Revenue Code of 1954, section 1221. While much of the discussion is valid for any deferred payment obligation, the discussions differentiating capital gain and ordinary income should be read with this limitation in mind.
A. Closed Transaction Treatment

An essential premise of tax law is that a transaction should be closed, i.e., completely taxed, in the year in which that transaction occurs. Those transactions which are not closed in the year in which they occur are either explicitly defined by the Internal Revenue Code or arise from judicial attempts to deal with problems for which the Code does not provide an adequate taxing mechanism. Closed transaction treatment is the norm and occurs when a taxpayer recognizes any gain or loss realized in the year of sale or exchange of an asset.

In a cash transaction the tax would be computed by determining the amount realized under section 1001(b) of the Code and subtracting the taxpayer's adjusted basis in the asset sold. The difference between the amount realized and the adjusted basis is the gain realized, which, pursuant to section 1002 of the Code, must be recognized in the year of the transaction.

When property other than money is received in exchange for the asset, the process of determining the gain realized and then recognizing that gain is more complex. First, section 1001(b) of the Code provides that the amount realized is the "sum of any money received plus the fair market value of the property (other than money) received." For example, if the taxpayer received $50 plus an automobile worth $50 in exchange for an asset with an adjusted basis of $75, section 1001(b) states that the amount realized would be the $50 in cash plus the $50 representing the fair market value of the other property, the automobile, for a total amount realized of $100. Once the amount realized is determined, section 1001(a) is used to determine the gain realized: the taxpayer's adjusted basis in the asset sold, $75, is subtracted from the amount realized on the sale or exchange, $100, which produces a gain realized of $25. Finally,

2. See, e.g., INT. REV. CODE OF 1954, §§ 1001, 1002, 1012.
3. INT. REV. CODE OF 1954, section 453 allows gain on qualifying installment obligations to be reported pro rata over the life of the obligation.
4. See, e.g., Burnet v. Logan, 283 U.S. 404 (1931) (mining royalty rights with no ascertainable fair market value were not an "amount realized" within the predecessor of INTERNAL REVENUE CODE OF 1954, section 1001(b), so the transaction could not be closed); Nina J. Ennis, 17 T.C. 465 (1951) (obligation held by cash basis taxpayer which was not salable was not the equivalent of cash and therefore not an amount realized); John B. Atkins, 9 B.T.A. 640 (1927) (cash basis taxpayer had no income when asset was not equivalent to cash).
5. INTERNAL REVENUE CODE OF 1954, section 1002 is the Code provision describing what is referred to as a closed transaction.
6. Id. § 1001(a).
7. Adjusted basis is defined at id. § 1011.
8. Id. § 1001(b).
section 1002 requires that the gain realized be recognized. After closing the transaction the taxpayer will pay tax on a $25 gain and will hold the automobile with a basis of $50. The basis is determined pursuant to section 1012. Under this section, the cost of the automobile is the total amount realized less both the money received and the value of any other property received.

Tangible assets, such as automobiles, which have a readily ascertainable sale value present no real problems of valuation, so taxing their receipt is fairly simple. Suppose, however, that the taxpayer received an installment sales contract instead of an automobile. To close this transaction according to the Code, the taxpayer would have to use the “fair market value” of the obligation. An economic analysis of this problem introduces some ambiguity into the language of the Code, since it suggests that “fair market value” may have several meanings.

For example, suppose that the obligation has a face value of $60 but a “sale value” of $50. Assume further that the obligation carries 8 percent interest. In this situation, the taxpayer will have an amount realized of $50 cash and an obligation with a fair market value (i.e., sale value) of $50. His amount realized is therefore $100, which again would produce a $25 gain.

Here, however, there is an additional problem: the taxpayer now has a basis of $50 in an obligation which will presumably bring him $60. In other words, he will realize a gain of $10 from retaining and collecting the obligation. This gain, which is attributable to the difference between the fair market value and the face value of the obligation, is taxed as ordinary income. The interest realized from the retention and collection of the note is also ordinary income which is recognized as it is realized.

Closed transaction treatment is straightforward when the amount realized consists of cash or assets with a readily ascertainable sale value. However, when deferred payment obligations are involved, closed transaction treatment may raise serious questions, such as how to determine fair market value.

B. Section 453 Treatment

Code section 453 is the congressional response to the problem of
taxing sales of assets which involve deferred payment obligations. This section provides for the recognition of gain on a sale when an installment obligation is part of the purchaser's payment; the seller of the asset may prorate the recognition of gain over the life of the obligation. In order to be eligible for section 453 treatment, the taxpayer may not realize more than 30 percent of the selling price in the year of the sale.

To illustrate the operation of this section, assume that a taxpayer has sold some land that he had held as a capital asset for $100,000, paid in the form of a 10-year note with $10,000 payable each year. Assume further that the taxpayer's adjusted basis in the land is $50,000. If this transaction were closed, the taxpayer would determine the sale value of the obligation (assume $90,000) and subtract his basis ($50,000) from the amount realized under section 1001(b) (leaving $40,000). This $40,000 difference would be treated as a capital gain, since it would be derived from the sale or exchange of a capital asset. The taxpayer would have a basis in the obligation of $90,000 and would realize $10,000 ordinary income from the collection and retention of the obligation.

Closed transaction treatment of such a sale creates a practical problem which section 453 has helped to alleviate. If the transaction described above were closed in the year of the sale, the taxpayer would pay a tax on that sale of 25 percent of $40,000, or $10,000. In this example, this tax is equal to the full amount actually realized by the taxpayer in the year of the sale. In many cases, the tax might greatly exceed the amount of cash available to pay the tax due. This anomalous situation might force the taxpayer to sell the obligation in order to raise the cash necessary to pay the tax, depriving the taxpayer of much of his bargain. Section 453 would not create such a disturbing result, since under that section the taxpayer would prorate each payment between gain and return of basis. The percentage of gain is determined under section 453(a) by reporting as income "that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price."

In the above example, the total contract price is $100,000 and

12. Id. § 453.
13. Id. § 453(b)(2)(A).
14. See notes 48-56 infra and accompanying text.
15. One need only reduce the taxpayer's basis to $10,000 in the hypothetical to produce a tax of $20,000—twice the amount the taxpayer has actually received—due and payable in the year of sale.
the total gain to be realized is that $100,000 contract price less the adjusted basis ($50,000). Thus, one-half of each payment would be reported as gain and one-half as return of basis. In this example, the total gain is deemed to be derived from the sale or exchange of the capital asset and none of the gain is attributed to the retention and collection of the debt. Therefore, all of the gain reported would be capital gain. The difference between closed transaction treatment and section 453 treatment is not in the total amount of gain recognized, but in the characterization of the gain and the timing of its recognition. Section 453 not only provides capital gains characterization, but defers most of the recognition of gain as well.

C. Open Transaction Treatment

An open transaction is a sale or exchange transaction held open for tax purposes as long as proceeds continue to be realized. Through open transaction treatment, the taxpayer may recover his entire basis before any gain is recognized. When the gain, if any, is finally recognized, it is treated as though it had been realized in the year of the sale in order to determine whether it should be treated as capital gain or ordinary income. In order to qualify for open transaction treatment, the taxpayer must meet the requirements of either the no ascertainable fair market value test or the cash equivalency test. The first test is available to any taxpayer regardless of accounting method; the second is available only to cash basis taxpayers.

1. The No Ascertainable Fair Market Value Test

The United States Supreme Court developed the no ascertainable

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17. Id. § 453(d)(1); Treas. Reg. § 1.453-9(a) (1971). These sections state that the entire gain or loss resulting from any disposition or satisfaction of the installment obligation will be considered as resulting from the sale or exchange of the original property sold. Such treatment places the gain within section 1221 and affords it capital gains treatment. Cf. Int. Rev. Code of 1954, § 1232(a).

18. For example, if the transaction is closed at $90,000, the taxpayer will recognize $40,000 in gain in the year of sale and $1000 in gain in each of the ten years that the obligation is paid off. See Shafpa Realty Corp., 8 B.T.A. 283 (1927). This would result in a total gain recognized of $50,000. Under section 453, the taxpayer will recognize $5,000 of gain in each year in which the obligation is paid, also for a total gain recognized of $50,000.

19. See, e.g., Burnet v. Logan, 283 U.S. 404 (1931); Nina J. Ennis, 17 T.C. 465 (1951). These cases should be compared with Internal Revenue Code of 1954, section 453, which allows the allocation of each installment payment between recovery of basis and gain.

20. See, e.g., Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948); Warren Jones Co., 60 T.C. 663 (1973), rev'd, 524 F.2d 788 (9th Cir. 1975).
fair market value test in *Burnet v. Logan*,\(^{21}\) in which the taxpayer received mining royalty rights in exchange for her stock in a mining company. The amount which the taxpayer would have ultimately realized was unknown at the time of the transaction, so the royalty rights could either have been worthless or quite valuable.\(^{21}\)

The Court determined that the royalty rights had no ascertainable fair market value and that the purchaser therefore realized nothing under the predecessor to section 1001 of the Code.\(^{23}\) When no amount is realized, no gain can be recognized. Each dollar paid to the taxpayer might have been the last to be realized, making it extremely difficult to assign a fair market value to the royalty rights.\(^{24}\) The Court concluded that the taxpayer was entitled to the full recovery of her basis before she had to recognize any gain. Since capital gains and ordinary income were taxed at the same rate in the year of the transaction (1916), the Court did not consider how the gain should be treated when it was finally realized and recognized.\(^{25}\)

The no ascertainable fair market value test was further developed in *Commissioner v. Carter*.\(^{26}\) The court there addressed the issue of whether the taxpayer should receive ordinary income or capital gains treatment on an open transaction and held that the gain should be treated as it would have been in a closed transaction. This decision made open transaction treatment extremely desirable, for not only would gain be deferred, but if it were derived from the sale of a capital asset, it would maintain its capital character. The

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22. The amount actually realized was quite substantial. *Id.* at 410-11.
23. INT. REV. CODE OF 1954, § 1001(b) provides:

   The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—
   (1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
   (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.
24. 283 U.S. at 411.
25. This raises an interesting problem which has never been discussed in the cases. If the tax rate has been changed from the rate extant in the year of the sale by the time the gain is actually recognized, at which rate should the gain be taxed? If one is to be consistent, it should be at the rate in effect in the year of the sale, since the gain is treated as if it were recognized in that year. Yet logically the gain is actually being realized in the year of recognition and in the dollars of that year, so it should bear the current tax rates.
26. 170 F.2d 911 (2d Cir. 1948).
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taxpayer could achieve the benefit of deferral with no corresponding detriment.27

As a result, the Commissioner has attempted to limit the availability of open transaction treatment to the extreme situation. The regulations to section 1001 and its predecessors state that "only in rare and extraordinary cases will property be considered to have no fair market value."28 Although the Commissioner has not prevailed in all of his attempts to prove an ascertainable fair market value,29 and thereby to preclude application of open transaction treatment, he has been successful in most cases.30 For example, even when the amount realized was only 50 to 70 percent of the face value of the obligation, courts have determined that the item has an ascertainable fair market value31 and that open transaction treatment is inappropriate.

2. The Cash Equivalency Test

An accrual basis taxpayer receiving property with an ascertainable fair market value must either treat the transaction as closed or elect section 453 treatment, but a cash basis taxpayer may still have an escape from any immediate recognition of gain. Money or property must be actually received if it is to be income to a cash basis taxpayer. In the words of the Board of Tax Appeals in John B. Atkins,32 "[I]n the case of one reporting income on the cash receipts and disbursements basis only cash or its equivalent constitutes

27. There usually is a trade-off of advantages in the Code between the taxpayer and the Commissioner; e.g., nonrecognition provisions (§§ 351, 368) prevent a step-up in basis, and depreciation deductions reduce basis (§ 1011). With open transaction treatment, however, there is no such trade-off. The taxpayer gets everything, while the Commissioner gets nothing.
29. See, e.g., Donald C. MacDonald, 55 T.C. 840 (1971) (rights to receive royalty based on production under patent had no ascertainable fair market value); Stephen H. Dorsey, 49 T.C. 606 (1968) (rights to receive future percentage of profits payments have no ascertainable fair market value).
30. See, e.g., Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967) (fair market value of 50% of face is still ascertainable fair market value and transaction must be closed); Commissioner v. Goldstein, 340 F.2d 24 (2d Cir. 1965) (rights to renewal commissions on insurance policies have ascertainable fair market value); Chamberlin v. Commissioner, 286 F.2d 850 (7th Cir. 1960) (rights to receive a percentage of future royalties under a patent-licensing agreement have no ascertainable fair market value); Pat O'Brien, 25 T.C. 840 (1971) (motion picture rights have ascertainable fair market value).
31. See, e.g., Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967); Gersten v. Commissioner, 267 F.2d 195 (9th Cir. 1959); John B. Atkins, 9 B.T.A. 140 (1927).
32. Id.
income." These words marked the birth of the cash equivalency test.

While several courts made use of this test from 1927 to 1951, the landmark cases were Nina J. Ennis and Estate of Clarence W. Ennis. The same contract for the sale of a retail liquor establishment was at issue in both cases. Nina J. Ennis held that the Commissioner had the burden of proving that a contract was in fact salable and therefore the equivalent of cash. Since the Commissioner introduced no evidence that there was a market, this burden was not met and there was no cash equivalence or income. In Estate of Clarence W. Ennis the Commissioner established that such contracts could be bought and sold, yet the court held that in order to be the equivalent of cash, a contract had to be negotiable in terms of salability. In other words, there had to be an actual market for the contract.

In the development of the salability test, the Clarence W. Ennis court used the terms negotiability and salability interchangeably, just as it confused the no ascertainable fair market value and cash equivalency tests. For example, the court first stated: "It was [an expert's] opinion that the contract involved here was not a salable contract." The court then quoted its opinion in Nina J. Ennis

33. Id. at 150.
34. See, e.g., Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929); Howard W. Johnston, 14 T.C. 560 (1950).
35. 17 T.C. 465 (1951).
37. The issue of whether there can be a fair market value even if there is no market is one that has been raised several times. It is fairly well established that there must be some sort of market. Darby Inv. Corp. v. Commissioner, 315 F.2d 551, 553 (6th Cir. 1963); Phipps Indus. Land Trust, 22 CCH Tax Ct. Mem. 1724, 1726 (1963); cf. Joan E. Heller Trust, 24 CCH Tax Ct. Mem. 1663, 1667 (1965). But see Chamberlain v. Commissioner, 286 F.2d 850, 853 (1960). A market may mean more than one potential buyer. Darby Inv. Corp. v. Commissioner, supra, at 553. Alternatively, it may simply mean a definite price that experts can attach to the property whether or not anyone would actually purchase the obligation. "It is not necessary to find any actual sales of like articles to establish market value." Gersten v. Commissioner, 267 F.2d 195, 197 (9th Cir. 1959). See also Birt E. Slater, 23 CCH Tax Ct. Mem. 1000, 1003 (1964). If the latter rule, i.e., that no actual market is necessary, is adopted, it logically must be applicable only to accrual basis taxpayers, since to be the equivalent of cash and therefore income to a cash basis taxpayer, an actual market must exist and the obligation must be convertible to cash at any time. See also note 47 infra.
38. Prior to this time the form of the contract ruled. If it was in a form which was prima facie negotiable, it was the equivalent of cash, but if it was non-negotiable in form but salable in fact, it was not the equivalent of cash. For a discussion of the triumph of form over substance, see Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).
for the same proposition: "In determining what obligations are the 'equivalent of cash' the requirement has always been that the obligation, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce." The decision in Clarence W. Ennis seemed to rest, however, on the salability notion. Because of the sold business' dependence on the continuation of its liquor license and the dependence of payment on the success of the business, the risk involved was very substantial. In addition, an expert testified that although this type of contract was indeed bought and sold, he was not aware that one had ever been sold with such a large balance. Because of the risk of nonpayment attributable to contingent circumstances (the continued holding of the liquor license), the contract was not truly salable and in no case was it worth more than 75 percent of its face value.

The final link of the pure salability test was forged in Cowden v. Commissioner, which ended the pretense of form over substance. The court made it clear that a note negotiable in form might still not be salable and therefore not the equivalent of cash.

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation. The principle that negotiability is not the test of taxability in an equivalent of cash case such as is before us, is consistent with the rule that men may, if they can, so order their affairs as to minimize taxes, and points up the doctrine that substance and not form should control in the application of income tax laws.

In addition, Cowden stated clearly the cash equivalency test: "If a consideration for which one of the parties bargains is the equivalent of cash it will be subjected to taxation to the extent of its fair market value."  

40. Id. (emphasis added).
41. 289 F.2d 20 (5th Cir. 1961).
42. Id. at 24.
43. Id. at 23.
Under the cash equivalency doctrine, if a deferred payment obligation is received by a cash basis taxpayer and that obligation is not the equivalent of cash, i.e., not readily convertible into cash, then it is not income in the year received and is not an amount realized under section 1001. This treatment requires that the transaction be kept open to determine the amount realized on the sale or exchange.

Open transaction treatment offers two advantages to the taxpayer: deferral and capital gains treatment of the entire gain recognized. Suppose, for example, that a taxpayer sells a capital asset with a basis of $50,000 for $100,000 in the form of a 10 year note payable at the rate of $10,000 principal per year plus 8 percent interest. Assume further, however, that the taxpayer is on the cash accounting method and that although the obligation is for a fixed amount, some type of contingency or severe risk exists which qualifies the obligation for open transaction treatment. If the taxpayer qualifies for open transaction treatment, he will recognize no gain whatsoever for the first 5 years, and in years 6 through 10, all collections will be taxed as capital gain. As with the installment method, a total of $50,000 of capital gains has been recognized, but with open transaction treatment, the taxpayer has enjoyed five years of complete deferral at no cost to himself.

II. THE ECONOMIC REALITIES OF TAXING DEFERRED PAYMENT OBLIGATIONS

Now that all three methods of taxation have been examined from a simple definitional standpoint, each method will be considered in terms of how closely it approaches economic reality; i.e., how closely each method comes to achieving ideal tax treatment within the confines of the current law. Before this discussion can be undertaken, however, some basic terms must be defined. "Sale value" will be used to mean the value for which (according to expert testimony) the obligation could readily be sold in the taxpayer's geographic area. This is the value which the courts have traditionally considered to be the equivalent of fair market value for purposes of determining the amount realized under section 1001(b). "Actual value" will be used to mean that value which would attach to the obligation in a perfect market, where buyers and sellers could readily obtain complete information about the issuer and where buyers and sellers would be aware of their mutual existence. This is the value the courts have traditionally attempted to establish in, for example, the stockholder dissenter cases.44

44. See, e.g., Levin v. Midland-Ross Corp., 41 Del. Ch. 276, 194 A.2d 50 (Ch.
A. The Problems of Closed Transaction Treatment

Closing transactions in the year in which they occur is the method by which most transactions are taxed. When less than 30 percent of the debt is paid in the first year, the taxpayer often may elect to pay the tax under section 453. Assume, however, that the taxpayer either fails to elect section 453 or for some reason, such as receipt of more than 30 percent of the debt, cannot so elect. To close the transaction, the fair market value of the obligation received must be established in order to ascertain the amount realized. In order to determine the fair market value of an obligation, an expert would usually be called upon to establish the price which the obligation would bring in the open market. The present sale value of an obligation to pay over time will rarely, if ever, be equal to the face amount of the obligation.

The difference between an obligation's face value and its sale value is called the discount. Discount is composed of three factors: (1) interest, i.e., the price of money, (2) risk, i.e., the likelihood that the entire obligation will not be paid, and (3) the imperfections of the marketplace, i.e., the fact that willing buyers and willing sellers may be unaware of each other, or that there is a lack of information about the issuer available to willing buyers. If only the first two factors, risk and interest, are present, then the sale value and the actual value of the obligation will be the same. With the widespread ability of investors and sellers to obtain and judge information in the modern market, most discounts are in fact comprised of only risk and interest. Such obligations present no significant problem of valuation for closed transaction treatment, since sale and actual value are the same. Fair market value, which may be either the sale or the actual value, will not be changed by such considerations.

1963); Jacques Coe & Co. v. Minneapolis-Moline Co., 31 Del. Ch. 368, 75 A.2d 244 (Ch. 1950); In re General Realty & Util. Corp., 29 Del. Ch. 480, 52 A.2d 6 (Ch. 1947).

45. It would be equal in the case of an obligation carrying an interest rate well above the going market rate if there was no more than the average risk. This situation rarely occurs in the year the obligation is received in exchange for a capital asset, since presumably the parties have bargained to approximate the going rate. In today's inflationary economy, this is even more improbable.

46. The interest rate includes factors representing the risk and the cost of the use of the money. The elements have been separated for purposes of this discussion to make it clear that the average cost of using money does not equal the total interest rate assigned to an obligation. The cost of using money is adjusted up or down, depending on the risk that the loaned money will not be repaid. This can be illustrated by comparing the "prime" rate of interest to the rate available for consumer loans. The money presumably would cost the same amount to use were it not for the difference in the probability of repayment.
In those instances in which the imperfect market has affected the sale price of an obligation, however, a major problem does arise. At what value should a transaction be closed? If the sale value is used, income which would have been capital gains in a more perfect market is converted into ordinary income. If actual value is used, the gain derived from the asset is treated as capital in nature, but this value may not be what Congress meant by fair market value.47

Capital gain is an addition to principal48 and the gain on the sale or exchange of a capital asset.49 Capital assets have been defined as assets of a permanent or fixed nature or those employed in carrying on a trade or business.50 The definition of capital assets is narrowly construed, in accordance with congressional intent, to afford capital gains treatment only in situations typically involving the realization of appreciated value accrued over a substantial period of time.51 The Code defines assets which are given capital gains treatment in sections 1221 and 1231(b)(1).52 While there has

47. The treasury regulations consistently define fair market value as the price at which the asset in question would exchange hands between a willing buyer and a willing seller. See, e.g., Treas. Reg. §§ 20.2031-1(b) (1965); 25.2512-1(1965). Treas. Reg. section 1.1001-1(a) (1972) states that fair market value is a question of fact. Since the terms "willing buyers" and "willing sellers" may support the conclusion that they must have market information, a taxpayer may be able to convince a court that an inefficient market cannot produce a fair market value; thus, the actual value and not the sale value is the fair market value. See also note 37 supra.


49. E.g., Rathborne v. Collector of Revenue, 196 La. 795, 200 So. 149 (1941).


51. Section 1221 states:

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a
been much disagreement over what property deserves capital gains treatment, it is clear that the gain must be derived from a sale or exchange of the property in order to be capital in nature.

Therefore, when a taxpayer sells a capital asset and takes a deferred payment obligation in exchange, the transaction is closed not at the face value of the obligation, but at its fair market value. This statement assumes that fair market value is equal to both the sale value and the actual value of the obligation. Thus, if market imperfections are not a major pricing factor, the gain derived from the sale of the asset will be treated as capital gain, and the difference between the fair market value of the obligation and its face value will be ordinary income derived from the retention and collection of the debt. This treatment is consistent with the concepts of ordinary income and capital gain developed under the tax law: Gain derived from the sale and exchange of the asset is given capital treatment and gain attributable not to the sale of the asset itself, but to the bargain involved in the form of payment, i.e., gain from the risk and interest factors accompanying deferred payment obligations, is treated as ordinary income.

Assume, for example, that a taxpayer sells a capital asset which has a cash sale value of $80,000. Although the purchaser of the asset agrees that the cash value is $80,000, he does not have $80,000 in cash. He therefore buys the asset with a deferred payment obligation having a face value of $100,000 but a present cash value of

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State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

Section 1231(b)(1) states:

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For purposes of this section—

(1) GENERAL RULE.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221.


54. Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962).

55. INT. Rev. CODE OF 1954, §§ 1221, 1231.

$80,000, the discount being solely attributable to risk and interest. The seller of the asset would close the transaction (assuming section 453 is not elected) at the obligation's fair market value of $80,000. Eighty thousand dollars will be the amount realized for purposes of determining gain, and any gain realized will be treated as capital gain since it derives from the sale or exchange of a capital asset. The taxpayer will then have a basis in the obligation of $80,000 and will realize $20,000 of income from retaining and collecting the obligation.

However, in situations where the actual value and the sale value of an obligation differ to any substantial degree, serious problems arise. If a taxpayer closes a transaction at the sale value of an obligation when the obligation's actual value is higher (the market having overly discounted the obligation due either to lack of adequate information about the issuer or to the inability of willing buyers to find willing sellers and vice versa), some of the gain actually derived from the sale or exchange of the capital asset is treated as if it were derived from the retention and collection of the debt. Suppose, for example, that the asset's cash value was $80,000 and the seller took an obligation with a face value of $100,000 and an actual value of $80,000. Assume further, however, that due to the lack of adequate information about the maker of the obligation, a private individual, no buyer could be found who would offer more than $70,000 for that obligation. Traditionally, the transaction would be closed at the $70,000 sale value as the obligation's fair market value. The taxpayer would then pay capital gains tax on $10,000 less than he would have paid in a normally efficient market and ordinary income tax on $10,000 more than that which would be payable in a more perfect market.

To illustrate the effects of this treatment, assume that a taxpayer is in the 50 percent tax bracket and is selling a capital asset worth $90,000, in which he has a basis of $50,000, in exchange for an obligation with a face value of $100,000 and an actual present value of $90,000. The obligation is payable in annual installments of $10,000 for ten years and for some reason the taxpayer has failed to elect under section 453. If the sale value of the obligation is also $90,000, i.e., no substantial effects of an inefficient market exist, then the taxpayer's amount realized of $90,000, less his basis of $50,000, will produce a gain realized of $40,000, which is recognized in the year of the sale as capital gain. The taxpayer will, at the time, pay a 25 percent tax of $10,000. He will take a basis of $90,000 in the obligation, and in each year in which the obligor makes a $10,000 payment, he will attribute 10 percent to gain from retention and
collection of the debt and 90 percent to a return of his basis in the obligation. In each year he will have ordinary income of $1,000, which, assuming a 50 percent bracket, will produce a tax of $500. On the total transaction, the taxpayer will have paid $15,000 in taxes. However, $5,000 of that amount is paid at the rate of $500 per year for ten years. Discounting this $5,000 back to its value in the year of sale, at an annual rate of interest of 8 percent, produces a tax of $3,355.04 in year-of-sale dollars. The taxpayer will therefore have paid $13,355.04 in taxes using the dollar value in the year of sale.

If there is a 10 percent market inefficiency factor, the result is different in actual present dollar value paid as taxes. If the sale value of the obligation is $80,000, all other factors being the same, the taxpayer will pay capital gains tax on $30,000, a tax amounting to $7500. Then, in each year of collecting on the obligation, he will recognize $2,000 per year in ordinary income, paying a tax of $1,000 each year. In nondiscounted dollars he has paid $17,500 in taxes, a difference of $2500.

However, when the payments are discounted to their value in the year of sale, the $10,000 paid over the ten years is worth $6,710.08. In dollar value in the year of sale, the taxpayer has paid $14,210.08 in taxes, a difference of $855.04, or approximately 6.4 percent, in actual year-of-sale dollars loss from the inefficient market. When the inefficient market factor exceeds 10 percent, the actual present value of dollars paid in taxes begins to assume even greater significance. If the sale value is $70,000, the present value of the

57. See, e.g., Victor B. Gilbert, 6 T.C. 10 (1946); Shafpa Realty Co., 8 B.T.A. 283 (1927). While this pro rata method of reporting the gain is the settled rule (although other than straight line methods may be used) and is justified in that the discount is actually unstated interest (except for inefficient market factors), another method of reporting this gain has been suggested. See, e.g., D. Herwitz, Business Planning 497-98 (1969); Corn Exch. Bank, 6 B.T.A. 158, 161 (1927). Perhaps an informal open transaction treatment, rather than an informal installment method, should be the method of taxing the discount on deferred payment obligations. Interest income should of course be recognized in the year realized when it is earned in that year for the use of money. It can, however, be argued that the discount more often represents a risk and not a money use factor, the stated interest comprising a fair price for money. Since the discount is the risk of nonpayment, no income is realized until that risk has passed; i.e., the obligation has been paid beyond its basis value. If this method were to be adopted, the taxpayer would first recover his full basis, then recognize ordinary income from any gain realized.

58. Using the formula \( pv = \frac{pmt}{i} \left[ \frac{1}{1+i^n} - 1 \right] \) where 
- \( pv \) = present value 
- \( pmt \) = annual tax payment 
- \( i \) = rate of interest = 8% 
- \( n \) = number of years = 10
taxes is $15,065.12, $1,710.08 or 12.8 percent more than the tax expense if the transaction is closed at its actual value. When $60,000 is the sale value, the taxes paid are the equivalent of $15,920.16, a tremendous difference of $2,565.12 or 19.2 percent. A value for closing purposes of $50,000 produces a tax of $16,775.20, a difference of $3,420.16, or 25.6 percent of taxes paid at the dollar value in the year of sale.

There is no evidence of how many obligations are significantly discounted due to inefficient market factors. One would doubt whether it is a substantial number of cases. The tax court has recently attempted to develop a doctrine that a substantial discount will render an obligation not the equivalent of cash and therefore not an amount realized to a cash basis taxpayer. Open transaction treatment is not truly an equitable solution to this problem, since it changes a situation disadvantageous to the taxpayer to one of great disadvantage to the Commissioner. Perhaps the only way to deal with these cases is that whenever a substantial discount exists, the court should allow the taxpayer, if he so desires, to go a step further and introduce testimony on the obligation's actual value. If the court is satisfied that the obligation's actual value is greater than its sale value, the transaction could be closed at the actual rather than sale value. While this procedure is burdensome, its existence may lead to more leeway in informal settlement procedures to avoid actual expert valuation and its attendant miseries. Allowing this small leeway should not open the floodgates of litigation, since the taxpayer would have a difficult burden of establishing a difference between sale and actual value. Therefore, while such a

59. This calculation includes $5,000 of capital gains tax paid in the year of sale and $1,500 per year in ordinary income in years one through ten, which equals $10,065.12, giving a total tax of $15,065.12.

60. The reduction in sale value results in a tax of $2,500 on capital gains in the year of sale and $2,000 per year on ordinary income. Discounted to present value, the latter amount would be the equivalent of $13,420.16 in year-of-sale dollars.

61. There is no gain in the year of sale and $5,000 of ordinary income tax would be paid in years one through ten, for a total tax of $16,775.20 in year-of-sale dollars.

62. The more activity there is in a market, the closer it theoretically approaches perfection. This occurs because willing buyers and willing sellers are able to find one another, and a volume of activity produces a basis for arriving at actual value by comparison with similar obligations.

63. Warren Jones Co., 60 T.C. 663 (1973), rev'd, 524 F.2d 788 (9th Cir. 1975).

64. See discussion in notes 19-46 supra and accompanying text.

65. See note 47 supra.

66. It is difficult to prove actual value in shareholder dissent cases, where "objective" evidence, such as corporate books, is available. This difficulty is magnified in attempting to value deferred payment obligations, since the primary form of proof would be expert testimony of the obligation's market value. The expert would make this determination on the basis of all the information available to him. Thus, to go
solution is not ideal, it is a practical resolution, fair both to the taxpayer and the Commissioner.

B. Section 453

The only real problem with tax treatment of deferred payment obligations pursuant to section 453 is the possibility that a taxpayer may pay a capital gains tax on gain which is not actually realized, although it has been recognized. Section 453 requires a pro rata recognition of return of basis and gain based on the proportion of the total contract price to the taxpayer's basis in the capital asset.

For example, if an obligation with a face value (total contract price) of $100,000, payable at the rate of $10,000 per year with a term of ten years, were given in exchange for a capital asset having a basis in the taxpayer's hands of $50,000, under section 453 the taxpayer would report each $10,000 payment as $5,000 return of basis and $5,000 capital gain. After nine years the taxpayer would have realized $90,000 and would have reported these payments as $45,000 return of basis in the asset sold and $45,000 capital gain. If the obligor defaults on the obligation at this point and never pays the remaining $10,000 payment, the taxpayer will have paid taxes on $5,000 of gain that he did not, in fact, realize. If default comes after eight years, the taxpayer will have been taxed on $40,000 of gain when he only actually realized $30,000. After seven years, tax on $35,000 of gain will have been paid on an actual gain of $20,000. Of course, had installment sales treatment not been elected, the taxpayer would have been required to pay a capital gains tax on the difference between the obligation's fair market value and his basis in the asset in the year of sale as well as the yearly recognition of ordinary income from the retention and collection of the debt.67

The "disadvantage" is therefore only a disadvantage as compared to open transaction treatment and not as compared to the usual closed transaction treatment.

Section 453 is more than fair in its treatment of taxpayers who in fact realize the total contract price of the obligation. If section 453 is elected, the taxpayer receives deferral of the gain over the life of the obligation as well as capital gains treatment on all the

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67. See discussion under Closed Transaction Treatment at text accompanying notes 9-11 supra, and note 57 supra.
gain realized. This should not be surprising, since section 453 was enacted to establish a clear method of taxing deferred payment obligations which struck a balance intended to meet the needs of the taxpayer as well as the needs of the Treasury.

C. Open Transaction Treatment

If an obligation is contingent or otherwise has no ascertainable fair market value, the taxpayer may be able to apply payments first to the recovery of basis through the application of open transaction treatment.\(^\text{68}\) A transaction cannot be closed or taxed pursuant to section 453 if the selling price, the actual value, and the total contract price cannot be determined. In such cases, open transaction treatment is fair and reasonable.

There is, however, another line of decisions which applied the cash equivalency test to determine the appropriateness of open transaction treatment.\(^\text{69}\) The leading cases in cash equivalency, the Ennis decisions,\(^\text{70}\) can well be analyzed under the no ascertainable fair market value standard. The taxpayers in the Ennis decisions might even have been entitled to open transaction treatment if they had been reporting on the accrual basis.\(^\text{71}\) However, there have been many attempts to expand the application of open transaction treatment to all cases where there is a substantial difference between the face value of an obligation and its sale value.\(^\text{72}\)

The Ninth Circuit, in *Warren Jones Co. v. Commissioner*,\(^\text{73}\) recently refused the Tax Court's attempt to establish the rule that any substantial discount of an obligation from its face value to its sale value makes it no longer the equivalent of cash and therefore not income to a cash basis taxpayer. *Warren Jones Co.* involved the sale of an apartment building by a cash basis taxpayer for a $20,000 down payment and an installment land contract for the balance, representing $133,000 payable over 15 years.\(^\text{74}\) The experts

\(^{68}\) See notes 19-46 supra and accompanying text.

\(^{69}\) Id.


\(^{71}\) See notes 34-41 supra and accompanying text. What the court comes close to stating here is that this obligation had such a great contingency that it could not be valued. This formulation of the fact situation is squarely within the *Burnet v. Logan* principle.

\(^{72}\) See discussion at notes 31-40 supra. What the courts' statements seem to be approaching is that the contingency which makes the obligation unsalable in fact precludes it from having an ascertainable fair market value (except in cases in which the obligation is nonnegotiable in fact).

\(^{73}\) 524 F.2d 788 (9th Cir. 1975), rev'g 60 T.C. 663 (1973).

\(^{74}\) Id. at 789.
at the trial testified that the obligation was salable for an approximate cash price of $118,000,\textsuperscript{75} an 11 percent discount. In addition, if the taxpayer sold the contract, he would be required to deposit approximately one-third of the proceeds from the sale of that contract in an interest-bearing account to which the purchaser of the obligation would have a right of recourse limited to the amount in the account.\textsuperscript{76} This right of recourse would lapse and the money in the account, with accrued interest, would be returned to the taxpayer when the debt had been reduced by one-third.\textsuperscript{77}

The Tax Court, in an en banc decision with three judges dissenting, held that this 11 percent discount was so substantial as to render the obligation not salable and therefore not the equivalent of cash. In resolving the issue of substantiality, the court considered not only the amount by which a discounting institution would reduce the face value of the contract but also the escrow account or security deposit that the taxpayer would have had to provide from the proceeds of the sale. In reversing, the Ninth Circuit relied on the availability of section 453 to this taxpayer in considering the availability of open transaction treatment.\textsuperscript{78} The court pointed to the Jones situation as the very situation with which section 453 was meant to deal.

Open transaction treatment provides far too great a tax break for the taxpayer who takes an obligation that, for whatever reason—interest, risk, or market inefficiency—is worth in present cash substantially less than the obligation's face value. In certain cases the Tax Court's concept in Jones might have validity. For example, it might be applied if an obligation with a face value of $1,000,000 was salable only for one dollar. Unless the obligation had such a tremendously long duration that its present value on the present value tables was actually only one dollar, it would be fair to assume that this obligation is not truly salable at all, and therefore is not income to the cash basis taxpayer. Of course, the 11 percent discount in Jones does not even approach the level of making the obligation unsalable. Eleven percent interest would be looked upon as a bargain to the sellers of installment obligations in today's market. Open transaction treatment, then, should be limited to all taxpayers who receive obligations with no ascertainable fair market value.

In addition, open transaction treatment should be available

\textsuperscript{75} Id.
\textsuperscript{76} Id.
\textsuperscript{77} Id.
\textsuperscript{78} Id. at 792-93.
to all cash basis taxpayers who receive obligations which are, in fact, not salable, i.e., not convertible into cash. The cash basis taxpayer who receives an obligation which is truly salable, i.e., where willing buyers and willing sellers exist for obligations of the same type and amount as that in the seller's hands, should not be permitted to obtain the substantial advantages of open transaction treatment regardless of the discount from face value to sale value. The taxpayer holding an obligation which is salable, even if it is substantially discounted, can close the transaction, or in most cases, can elect to report the sale pursuant to section 453. As the Ninth Circuit said in Jones, this is the relief provided by Congress for just such situations. When one weighs the tremendous advantage given to the taxpayer under open transaction treatment against the concepts of equality under the tax laws and the need for certainty as well as the legitimate need for revenue, open transaction treatment for the Jones type of taxpayer cannot be justified. This is particularly true in view of the equitable, certain, and advantageous treatment afforded by section 453.

III. Conclusion

This Note has considered how the various types of tax treatment for deferred payment obligations operate and the problems with each of them. The practical difference, the actual dollar value of taxes paid, demonstrates the advantages of section 453 treatment and the special advantage of open transaction treatment. If a capital asset with a basis of $50,000 is sold in exchange for an obligation with a face value of $100,000 and a sale (and actual) value of $90,000, the taxpayer will pay $13,355.04 in taxes in year-of-sale dollars. If section 453 is elected, the year-of-sale value of the total taxes paid is $8,387.60, a substantial and fair tax savings of 37.2 percent. If the taxpayer can somehow qualify for open transaction treatment, the total tax will be $6,793.42, a tax savings of 49 percent, which is unjustifiably advantageous.

A close examination of the problems of each method of taxation has demonstrated that section 453 is by far the clearest, easiest to use, and, above all, fairest method of taxation. Closed transaction

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79. Id. at 792.
80. See text accompanying notes 57-58 supra.
81. See note 58 supra.
82. Warren Jones Co. v. Commissioner, 524 F.2d 788, 792 (9th Cir. 1975).
83. Ten thousand dollars in capital gain is recognized in each of years six through ten. Therefore, $2,500 is paid in tax each year. Discounted, these payments equal $6,793.42 in year-of-sale dollars.
treatment is fair when more than 30 percent of the price is realized in the year of sale, since the congressional policy behind granting the tax break\textsuperscript{84} no longer exists. Open transaction treatment should certainly be available to sellers who receive obligations with no ascertainable fair market value whether due to the nature of the obligation\textsuperscript{85} or contingencies resulting in its being unmarketable and unsalable in fact. However, the doctrine that a substantial discount renders an obligation not the equivalent of cash\textsuperscript{86} should not be employed except in those cases where the obligation is truly unsalable,\textsuperscript{87} to give the tremendous advantages of open transaction treatment to a taxpayer who has received the equivalent of cash.

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\textsuperscript{84} Int. Rev. Code of 1954, § 453; see Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962)

\textsuperscript{85} E.g., obligations such as in Burnet v. Logan, 283 U.S. 404 (1931). See note 4 supra.

\textsuperscript{86} Warren Jones Co., 60 T.C. 663 (1973), rev'd., 524 F.2d 788 (9th Cir. 1975).

\textsuperscript{87} See text at supra.