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Conflicting decisions by the Ninth Circuit and the Tax Court have created an atmosphere of uncertainty regarding the treatment of assumed liabilities payments for purposes of the thirty-percent test under section 453 of the Internal Revenue Code. After analyzing the approaches taken by the two courts, the author concludes that the Tax Court's holding is the better of the two. In addition to pointing out the foregoing uncertainty, Mr. Koblenz believes that the method of computing the contract price to be used in the installment method of reporting income is also in doubt.

THE INTERNAL Revenue Code has long taken cognizance of the fact that not every sale of property is for cash and that therefore not every seller receives sufficient cash in the year of sale to pay the entire income tax attributable to his gain. Section 453 of the Internal Revenue Code of 1954 allows a seller to spread the gain realized on a deferred payment sale over the period during which payments are received.[1] This is called the installment method of reporting income. With respect to a sale of real property or a casual sale of personal property (other than inventory) in excess of $1,000, the installment method may be utilized only if the payments in the taxable year of sale do not exceed thirty percent of the selling price.[2] The relevant taxable year of sale is the seller's fiscal year, which may or may not be a calendar year. For purposes of this thirty-percent test, payments are not limited to cash. In fact, the transfer of any property, other than evidences of indebtedness of the buyer, will constitute a payment to the seller.[3]

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[1] INT. REV. CODE OF 1954, § 453(b)(1) [hereinafter cited as CODE]. The predecessor of § 453 first became part of the Internal Revenue Code in 1921. It, in turn, was preceded by articles 116 and 117 of Regulations 33 (revised) of 1918.

[2] CODE § 453(b)(2).

[3] CODE § 453(b)(2)(A)(ii) expressly states that payments do not include evidences of indebtedness of the buyer.

Whether liabilities of the seller assumed and paid by the buyer in the seller's year of sale should also be counted toward the thirty percent of the selling price as payments in the year of sale was the subject of two judicial decisions in 1966.[4] As an example, assume that in 1967 Seller, a calendar year taxpayer not a dealer in paintings, owns a painting having a cost basis to him of $4,000. Seller agrees to sell the painting to Buyer for a total consideration of $10,000: $1,500 in cash to be paid by Buyer to Seller in 1967 and $5,500 of deferred payments, the first occurring in January 1968. The remainder of $3,000 is to be paid by Buyer's assuming an obligation of Seller to a third party in the amount of $3,000. The sale is consummated, and, in addition to paying Seller the $1,500 in cash, Buyer pays to the third party in 1967 $1,000 of the $3,000 obligation. For purposes of the thirty-percent test, do the payments in the year of sale equal only $1,500 (the cash received in 1967), in which event the installment method may be used? Are the payments $2,500, (the cash plus the $1,000 assumed and paid in 1967), thus permitting use of the installment method? Or are the payments $4,500 (the amount of cash plus the total liabilities assumed), in which event the installment method may not be used and all of Seller's gain, $6,000, would have to be reported in 1967 even though Seller received only $1,500 in cash? Until this past year one could not be sure of the answer to these questions because there was no authority directly in point. Now, one cannot be sure because decisions of both the Ninth Circuit Court of Appeals and the Tax Court, which were handed down within nine days of each other, are directly in conflict and provide different answers to the questions. In *United States v. Marshall*,[5] decided by the Ninth Circuit, the taxpayer was a sole proprietor who sold his business to a corporation. The total sales price, in round figures, was $110,000. During the year of sale the sole proprietor received $14,000 directly from the corporation, and the corporation in the ordinary course of business paid obligations totaling $25,000 for which the sole proprietor had been personally liable.[6] Obviously, $14,000 is less than thirty percent of $110,000, but $14,000 plus $25,000, a total of $39,000, exceeds thiry percent of $110,000. Thus, if the amount of liabilities assumed and paid in the year of

[4] United States v. Marshall, 357 F.2d 294 (9th Cir. 1966); Ivan Irwin, Jr., 45 P-H TAX CT. REP. & MEM. DEC. ¶ 45.53 (March 25, 1966).

[5] 357 F.2d 294 (9th Cir. 1966).

[6] *Id.* at 296.

sale were added to the payments received by the taxpayer-seller in the year of sale, the taxpayer would not have been permitted to use the installment method of reporting income. Affirming the Southern District of California, the Ninth Circuit held that the liabilities assumed and paid were not to be included as payments in the year of sale.[7] The decision relied primarily on section 1.453-4(c) of the Treasury Regulations which concerns the sale of mortgaged real property.[8] The section provides that with respect to real property sold subject to a mortgage, the amount of the mortgage is not counted as a payment in the year of sale except to the extent that it exceeds the basis of the property sold.[9] (The exception is of no concern here.) The *Marshall* court considered the assumption of current business obligations by the purchaser corporation to be analogous to the assumption of a mortgage by a purchaser of real property; therefore, no assumed liabilities, whenever paid, should be deemed to be payments in the year of sale.[10] Emphasizing the fact that the installment method of reporting income was enacted to relieve taxpayers who receive only a small portion of the sale price in the year of sale from the obligation of paying the tax on the entire profit in that year, the Ninth Circuit pointed out that the seller received only $14,000 in cash in the year of sale but the total tax attributable to the seller's gain exceeded $20,000.[11] The court also referred to the administrative difficulty of a seller's determining what obligations had been paid by a buyer in the seller's year of sale.[12] Finally, the court pointed out that since the agreement of sale did not require the current liabilities to be paid off within the first year, this was within the buyer's control, and the seller should not be penalized.[13]

Nine days later, in *Ivan Irwin, Jr.*,[14] the Tax Court had an opportunity to consider a case in which the facts were very similar, except in amounts, to those found in the *Marshall* case, but the Tax Court did not agree with the taxpayer's reasoning or that of the Ninth Circuit. The Tax Court did agree, however, that all liabilities as-

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7 *Ibid.*

8 Treas. Reg. § 1.453-4(c) (1958) [hereinafter cited as Reg.].

9 Reg. § 1.453-4(c) has been extended to sales of personal property. Stephen A. Cisler, Jr., 39 T.C. 458, 466 (1962), I.T. 2468 VIII-1 CUM. BULL. 159, 160 (1929).

10 357 F.2d at 295.

11 *Ibid.*

12 *Id.* at 296.

13 *Ibid.*

14 45 P-H TAX CT. REP. & MEM. DEC. ¶ 45.53 (March 25, 1966).

sumed by the buyer did not automatically constitute payment in the year of sale.[15] The decision made it quite clear that the assumption of liabilities in itself does not constitute a payment to the seller unless the seller's liability is actually cancelled by the third party, thereby releasing the seller from personal liability.[16] Nevertheless, if assumed liabilities are *paid* in the year of sale, they do constitute payments in that year.[17] The Tax Court was fully aware that in an installment sale if the entire gain is taxed in the year of sale, the taxpayer might well be faced with a substantial tax without having a sufficient portion of the proceeds available to pay the tax.[18] The court acknowledged that the installment method of reporting was designed to alleviate this hardship;[19] however, the court felt that the theory which underlies the thirty-percent test is as applicable to situations in which the seller is relieved of a personal liability as it is to situations in which the seller receives cash or other tangible property in the year of sale.[20] The reasoning was that if a buyer pays a personal debt of the seller in the year of sale, this has the same effect as if the buyer had given the seller cash which the seller used to pay his own debt. By being relieved of a personal liability in this manner, the seller's other personal funds are freed to be used in paying the tax.[21] The Tax Court dismissed the relevance of Treasury Regulation section 1.453-4(c) by stating that it should be read, apparently even with respect to real estate, to apply only to liabilities which are assumed but not paid in the year of sale.[22]

Thus, a direct conflict exists between the Ninth Circuit Court of Appeals and the Tax Court.[23] Obviously, tax counsel cannot

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15 *Id.* at 388.
16 *Id.* at 390.
17 *Ibid.*
18 *Id.* at 389.
19 *Ibid.*
20 *Ibid.*
21 *Ibid.*
22 *Id.* at 392.
23 A very recent Tenth Circuit Court of Appeals decision Riss v. Commissioner, 368 F.2d 965 (10th Cir. 1966), involved the issue of whether cancellation by the buyer of the seller's indebtedness to it constituted payment in the year of sale. In holding that such cancellation was payment in the year of sale, the Tenth Circuit distinguished *Marshall* by showing that in the case before it the buyer cancelled the seller's indebtedness owed directly to the buyer. The buyer had not assumed the seller's indebtedness to a third party as in *Marshall. Id.* at 968. A weak inference can be drawn from the *Riss* decision that the Tenth Circuit would have followed *Marshall* if the facts were substantially similar. No mention of the *Irwin* case was made in the *Riss* decision.

rely on the Ninth Circuit decision when such a conflict exists and, as a matter of fact, it would be this writer's opinion that the Tax Court rationale will ultimately prevail.

If the facts outlined earlier concerning the sale of the painting[24] were presented to the Ninth Circuit Court of Appeals, it would no doubt hold that only the $1,500, the cash received in 1967, would constitute payments in the year of sale. The Tax Court, on the other hand, would hold that $2,500, the amount of cash plus the liabilities assumed and paid in 1967, would constitute payments in the year of sale; and it is now doubtful that even the Commissioner of Internal Revenue, although he did make the argument in the *Irwin* case,[25] would contend that the $4,500, the cash plus the assumption of all the liabilities, would constitute payments in the year of sale.[26]

A number of suggestions can be made if it appears in the planning stage that the assumption of liabilities by the buyer will exceed the thirty-percent limit. First, seller's counsel should limit the right of the buyer to prepay any of the buyer's notes in the year of sale.[27] Another suggestion is for the buyer and seller to provide in their agreement of sale which liabilities, if any, the buyer may pay to third parties in the year of sale. In this respect, the timing of the transaction may be of extreme importance. If the sale occurs late in a seller's taxable year, the buyer may have no reluctance at all to agree not to discharge the liabilities he assumes until the following taxable year. Still another approach, if possible, is to have the seller retain sufficient liquid assets to pay certain of the liabilities which might otherwise be assumed by the buyer. This serves to reduce the amount of possible payments, but it also reduces the selling price so that the thirty-percent limit is applied against a smaller figure. For example, with a selling price of $100,000 containing assumed liabilities of $40,000, the thirty-percent limit is $30,000, and the seller, depending upon the amount of assumed liabilities actually paid by the buyer in the year of sale, may be prevented from using the installment method. If the seller

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24 See text accompanying note 4 *supra.*

25 Ivan Irwin, Jr., 45 P-H. TAX CT. REP. & MEM. DEC. ¶ 54.53, at 390-91 (March 25, 1966).

26 See text accompanying note 16 *supra.*

27 There is nothing in the tax law to prevent the seller from selling the installment notes to a third party in the year of sale. In such event, the proceeds will not be counted toward the thirty-percent limitation, but the seller will have to report the gain attributable to such notes in the year in which he sells them. CODE § 453(d).

were to retain $20,000 of assets and the buyer were to assume only $20,000 (instead of $40,000) of liabilities, the assumed liabilities would be under the thirty-percent limit — but not by $10,000. The assumed liabilities are $4,000 under the limit because the limit has changed from thirty percent of $100,000 to thirty percent of $80,000.

The possibility also exists of separating an anticipated sale into two transactions so that certain assets, hopefully those on which the least gain would be recognized, would be sold in the non-installment transaction for cash and the assumption of liabilities. In a separate transaction the other business assets would be sold on the installment method and so reported. The difficulty, however, is the probability that the Internal Revenue Service would lump the transactions together.[28] Nevertheless, such fragmentation of assets was approved by the Tax Court in 1963 where the seller of a sole proprietorship liquor store divided the assets into inventory and non-inventory assets.[29] Noting that inventory is excluded from the installment privilege, the Tax Court upheld the taxpayer's treatment of the inventory sale for cash and the non-inventory assets on the installment method.[30]

Once the thirty-percent limitation has been conquered, it then becomes necessary to determine the percentage of gain that is to be reported with each installment payment. This is the proportion which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.[31] The problem then becomes what is the total contract price? Returning to the example of the sale of the painting, the selling price is clearly $10,000, but $3,000 is not paid directly to the seller. Hence, the installment payments "actually received" by the seller will be only $7,000. In order that all the gain be reflected, it would appear that the total contract price should be $7,000. The theory of the *Marshall* case, as the Ninth Circuit applies Treasury Regulation section 1.453-4(c), does seem to require such a result. The assumed liabilities would not be counted either as payments or as part of the total contract price. If the *Irwin* case is correct, however, and the $1,000 of liabilities assumed and paid in the year of sale is deemed to be a payment in the year of sale, one would assume that the total contract

28 See, *e.g.*, Blackstone Realty Co., 1966 P-H TAX CT. REP. & MEM. DEC. (35 P-H Tax Ct. Mem.) ¶ 66156 (July 8, 1966).

29 Andrew A. Monaghan, 40 T.C. 680 (1963).

30 *Id.* at 687-88.

31 CODE § 453(a)(1).

price has to be increased to $8,000. On the other hand, perhaps the Tax Court would hold that the $1,000 counts as a payment for purposes of the thirty-percent limit but does not count as an installment actually received so that no gain is reported as the buyer pays off the assumed liabilities. If so, the Tax Court would agree with the Ninth Circuit that $7,000 is the total contract price.

Still another possibility is that the total contract price should equal the total selling price of $10,000.[32] If this is so, the seller would have the burden of knowing when each of the assumed liabilities is paid by the buyer and reporting such payments as though they were payments received by the seller himself. This appears to fly directly in the face of the statutory language of reporting that proportion of installments "actually received." The writer is inclined to believe that the proper total contract price is $7,000 and that assumed liabilities, as they are paid, may be ignored. This solution would require that a larger portion of the gain be reported with each payment received,[33] but it has the convenience — both to the Internal Revenue Service and the taxpayer — of reporting gain only as payments are received directly by the seller. Further developments with respect to the installment method of reporting income must be awaited before the answers to the questions raised in this article can be given with certainty.

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32 See the treatment of interest and taxes assumed in the example given in 3 CCH 1966 STAND. FED. TAX REP. ¶ 2871.10.

33 With gross profit remaining constant, a lower contract price means a higher percentage of gain to be reported upon receipt of each installment.