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DEFERRED PAYMENT SALES OF UNIMPROVED REAL ESTATE: TAX CONSIDERATIONS FOR THE CASH BASIS SELLER

The recent trend toward urbanization has created an almost insatiable appetite for suburban and rural land surrounding the inner city. Property owners in these areas have been faced with a deluge of offers from prospective purchasers seeking to acquire this land. This growing demand has fostered spiraling property values, often far exceeding the owner's basis in his property.

If an owner accepts one of the numerous offers to buy his land, the sale is likely to involve some type of deferred payment plan.[1] The type employed will result in differing tax liabilities occasioned by the uncertainty of federal tax statutes applicable to property transactions. For instance, the seller may recognize a greater taxable gain in the year of sale than the amount received as a cash downpayment,[2] or the taxpayer may unexpectedly find that deferred payments will be taxed as ordinary income rather than at capital gains rates.[3] In either case, the result will certainly be distasteful, if not disastrous, to the selling landowner.

In view of this uncertainty, every attorney must be aware of the varied tax consequences attending each different transaction. This commentary details the various pitfalls and uncertainties inherent in deferred payment sales of real estate[4] and presents certain alternatives available to cash basis sellers.

VALUATION OF PURCHASER'S OBLIGATIONS TO PAY

Gross income includes "gains derived from dealings in property."[5] The amount of gain recognized[6] as income is the excess of the amount realized[7] by the seller over the adjusted basis[8] of his property.[9] While the adjusted basis will usually be measured by the owner's acquisition cost,[10] the determination of the amount realized poses greater problems. In addition to cash, the value of any other property received by the seller must be included in the amount

1. In addition to the types of deferred payment plans covered by this commentary, a taxpayer should investigate the possible use of such devices as an option, trust, or private annuity plan to effect a land transaction. *See generally* Voegelin, *How To Defer Tax on the Sale of Real Estate, a Business, or Other Property*, 10 TAXATION FOR ACCOUNTANTS 168, 177 (1973).

2. See text accompanying notes 34-37 *infra*. This may create a hardship because the taxpayer may not have enough cash to pay his tax liability.

3. See text accompanying notes 74-87 *infra*.

4. To avoid problems with depreciation and recapture, this commentary will involve only the sale of unimproved land.

5. INT. REV. CODE OF 1954, §61(a)(3). Certain sales or exchanges of property may be specifically nontaxable. *See, e.g.,* INT. REV. CODE OF 1954, §§121, 1031-39.

6. INT. REV. CODE OF 1954, §1002.

7. INT. REV. CODE OF 1954, §1001(b).

8. INT. REV. CODE OF 1954, §1012.

9. INT. REV. CODE OF 1954, §1001.

10. INT. REV. CODE OF 1954, §1012. To determine the basis of property acquired by gift, see INT. REV. CODE OF 1954, §1015. The basis of property acquired from a decedent is determined by INT. REV. CODE OF 1954, §1014.

realized.[11] Under a deferred payment sale this property will likely consist of some form of purchaser's obligation or promise to pay. The valuation of these obligations will have a significant impact upon the amount, character, and tax consequences of any gain realized by the seller.

Once an obligation has been received by a seller, a court may include the obligation's fair market value in the amount realized by utilizing the judicial doctrine of cash equivalency.[12] Inclusion will often depend upon the taxpayer's ability to convert the purchaser's obligation into cash by sale or other disposition.[13] The relevant factors in assessing value (cash equivalent) include the instrument's negotiability,[14] marketability,[15] transferability and assignability,[16] conditions precedent or other stated contingencies,[17] the obligor's financial status,[18] and the form of the obligation.[19] While many of these factors are beyond the taxpayer's control, he does have a voice in the form of the obligation he will accept from a purchaser. In most courts this factor carries significant weight in the process of determining value and cash equivalency.[20]

Bonds, mortgages, and other adequately secured promissory notes are usually considered to have a fair market value equal to their face amount.[21] Mere contractual obligations, however, are less likely to be so valued by

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11. *See* Jacobowitz, *Cash Basis Taxpayers Can Realize Income Under the IRS Doctrines Without Being Aware of It,* 5 TAXATION FOR ACCOUNTANTS 484 (1970). *See also* Crane v. Commissioner, 331 U.S. 1 (1947) (amount of mortgage assumed included in amount realized).

12. *See* Schlude v. Commissioner, 372 U.S. 128 (1963) (negotiable note held to be the equivalent of cash in the amount of face value; Rapid Transit Land Sales Co., 20 B.T.A. 608 (1930) (contract held to be the equivalent of cash to the extent of 65% of face value). *See generally* 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§11.01-.08 (J. Malone ed. 1967); Schlossberg, *"Cash Equivalent" and "Constructive Receipt" — How These Doctrines Bring Immediate Taxation,* 22 J. TAXATION 18 (1965). At least one commentator has suggested that the cash equivalency doctrine is not the same thing as the fair market value concept, and that the latter is a much broader concept. Cain, *Taxation of Promises To Pay,* 8 GA. L. REV. 125, 131 (1973). The courts, however, have failed to make such a distinction. *See, e.g.,* Warren Jones Co., 60 T.C. No. 70 (Aug. 7, 1973); Harold W. Johnston, 14 T.C. 560 (1950).

13. Charles C. Ruprecht, 16 B.T.A. 919, *aff'd,* 39 F.2d 458 (5th Cir. 1930). *See generally* 2 J. MERTENS, *supra* note 12; Note, *Taxation of Deferred Payment Sales of Realty and Casual Sales of Personalty,* 1966 UTAH L. REV. 195, 205-14.

14. Bedell v. Commissioner, 30 F.2d 622, 624 (2d Cir. 1929); *cf.* Harold W. Johnston, 14 T.C. 560 (1950). *But see* Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

15. *E.g.,* Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961); Curtis R. Andrews 23 T.C. 1026 (1955).

16. *See* Levine v. Commissioner, 324 F.2d 298 (3d Cir. 1963); Rev. Rul. 68-606, 1968-2 CUM. BULL. 42.

17. *E.g.,* Burnet v. Logan, 283 U.S. 404 (1931); Stephen H. Dorsey, 49 T.C. 606 (1968).

18. See Estate of William F. Stahl, 52 T.C. 1591 (1969), *aff'd,* 442 F.2d 324 (7th Cir. 1971).

19. See text accompanying notes 21-33 *infra.*

20. For a collection of the cases, see Desmond, *Sales of Property Under the Deferred-Payment Method,* 32 TAXES 40, 41-44 (1954). *See also* Note, *supra* note 13. Although a court concerned with the equities of a particular situation may justify its decision on the basis of a single factor, the advocate should attempt to produce evidence on all valuation factors.

21. Schlude v. Commissioner, 372 U.S. 128 (1963); *cf.* Gunderson Bros. Eng'r Corp., 42 T.C. 419 (1964). *See generally* 2 J. MERTENS, *supra* note 12, §§11.05-.07.

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courts.[22] Of these latter obligations, executory contracts[23] are least likely to be valued or included in the amount realized by the seller.[24] Generally, courts have treated such contracts as accounts receivable and have held that they are not the equivalent of cash.[25]

On the other hand, treatment of a right to future payments evidenced only by an installment land sales contract has been more uncertain. Earlier cases tended to include the fair market value of such contracts in the amount realized.[26] These decisions focused on the similarities between land contracts and mortgages, according little weight to the difficulty of disposing of such contracts for an equivalent amount of cash.[27] The Tax Court later discarded this position in *Nina J. Ennis*[28] and began to require that an obligation be freely negotiable before it could be considered the equivalent of cash.[29] The court conceded that the sale was complete and that the contract possessed many elements of a mortgage, but believed it lacked the necessary elements of negotiability and transferability.[30] *Ennis* seems to represent the Tax Court's current posture on land contracts.[31] When a particular obligation has been in fact salable, however, the Tax Court has occasionally refused to follow the holding in *Ennis*.[32] The Commissioner's nonacquiescence in cases following

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22. *E.g.*, Bedell v. Commissioner, 30 F.2d 622, 624 (2d Cir. 1929); Harold W. Johnston, 14 T.C. 560 (1950). *See generally* 2 J. MERTENS, *supra* note 12, §11.06.

23. An example is a contract under which the purchaser agrees to pay a percentage of profits or a price per unit of future output. Burnet v. Logan, 283 U.S. 404 (1931). Unlike the mortgage or negotiable note, these obligations are generally without a stated face value, and an established market for their sale probably will not be available.

24. *E.g.*, Burnet v. Logan, 283 U.S. 404 (1931); Stephen H. Dorsey, 49 T.C. 606 (1968).

25. Courts have treated such contracts as evidence of indebtedness and not as instruments of payment. *E.g.*, Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929); Edelman v. United States, 329 F.2d 950 (Ct. Cl. 1964); Estate of Clarence W. Ennis, 23 T.C. 799 (1955).

26. *E.g.*, Rapid Transit Land Sales Co., 20 B.T.A. 608 (1930), *acquiesced in*, X-1 CUM. BULL. 54 (1931); Gertrude H. Sweet, 8 B.T.A. 404 (1927), *acquiesced in*, VII-1 CUM. BULL. 30 (1928). *See also* Rev. Rul. 17-3692, VII-1 CUM. BULL. 62 (1928).

27. *See* cases cited note 26 *supra*.

28. 17 T.C. 465 (1951).

29. The *Ennis* court held that an installment land sales contract, unsupported by any other evidence of indebtedness, was not the equivalent of cash and was not includable in the amount realized by the seller. *Id.* at 470. Note, however, that in a later case involving the same contract there was some evidence that the contract should be valued at 50% of face. The court was not impressed with this evidence and again held that the particular contract had no fair market value. The court may have been swayed by the fact that continued use of the property was contingent upon successful annual renewal of a state liquor license. Estate of Clarence W. Ennis, 23 T.C. 799, 802 (1955).

30. 17 T.C. at 470.

31. For examples of cases following the *Ennis* rationale, see Guffey v. United States, 222 F. Supp. 461 (D. Ore. 1963); Estate of Coid Hurlburt, 25 T.C. 1286 (1956), *nonacquiesced in*, 1956-2 CUM. BULL. 10.

32. Herbert Kaufman, 23 CCH Tax Ct. Mem. ¶26,786 (1964) (installment land contract valued at 70% of face); Phipps Indus. Land Trust, 22 CCH Tax Ct. Mem. ¶26,435 (1964) (contracts valued where salable). A 1973 Tax Court case held, however, that a contract need not always be valued even though it might be salable. Warren Jones Co., 60 T.C. No. 70 (Aug. 7, 1973). *See* text accompanying notes 102-112 *infra*.

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Ennis and his insistence upon valuation[33] promise additional litigation in this area.

In the valuation of obligations, as is usually the case, the Commissioner's determination is presumed correct.[34] Thus, the taxpayer has the burden of proving a contrary estimate of value.[35] If an obligation received from a sale of property is accorded any value, however, such valuation closes the transaction and subjects the seller to immediate tax liability for any gain.[36] Therefore, assuming that the taxpayer produces evidence sufficient to show a reduced value, all gain computed on the basis of that value will nevertheless remain recognizable and reportable in the year of sale.[37] If, on the other hand, the taxpayer can demonstrate that the obligations are incapable of valuation, the transaction remains "open"[38] and recognition of any gain is deferred.[39] To accomplish this result the Treasury Regulations seemingly require the taxpayer to prove the obligation received had no value at all.[40] The courts have interpreted the Regulations, however, as requiring the taxpayer to show only that the value of an obligation cannot be "ascertained."[41] Initially, the Internal Revenue Service indicated it would seek to ascertain a value where only a rough estimate could be made.[42] The Service has now changed this position, requiring valuation only if a *reasonable* estimate can be made.[43] The success with which the taxpayer believes he can advocate his estimate of value will

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33. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, 17.

34. *See, e.g.*, Fihe v. Commissioner, 265 F.2d 511, 513 (9th Cir. 1958); A & H Tool & Supply Co. v. Commissioner, 182 F.2d 300 (10th Cir. 1950); *cf.* New York Life Ins. Co. v. Gamer, 303 U.S. 161, 171 (1938). *See generally* Note, *supra* note 13, at 203-20.

35. *See, e.g.*, Chamberlin v. Commissioner, 286 F.2d 850 (7th Cir. 1960) (contract valued where taxpayer offered *no* evidence to support his contention that the contracts had no ascertainable value); Boudreau v. Commissioner, 134 F.2d 360 (5th Cir. 1943), *aff'g* B.T.A. 390 (1941). See text accompanying notes 14-20 *supra*.

36. Pat O'Brien, 25 T.C. 376, 385 (1955) (valuation of contractual royalty rights in the motion picture industry). If the statutory requirements are set, the taxpayer can elect to report on the installment method under INT. REV. CODE OF 1954, §453. Thus, some deferral of tax incident to gain might still be possible. See text accompanying notes 50-59 *infra*.

37. Herbert Kaufman, 23 CCH Tax Ct. Mem. ¶26,786, at 764-65 (1964); *cf.* Fihe v. Commissioner, 265 F.2d 511, 513 (9th Cir. 1958); Alvin B. Lowe, 44 T.C. 363 (1965); W. H. Batcheller, 19 B.T.A. 1050 (1930).

38. Commissioner v. Carter, 170 F.2d 911, 912 (2d Cir. 1948), *interpreting* Burnet v. Logan, 283 U.S. 404 (1931).

39. *Id.* See text accompanying notes 88-112 *infra*.

40. "If the obligations received by the vendor have *no* fair market value." TREAS. REG. §1.453-6(a)(2) (emphasis added), they are not includable in the amount realized from a sale, "[b]ut only in rare and extraordinary cases will property [obligations] be considered to have *no* fair market value." TREAS. REG. §1.1001-1(a) (emphasis added). *See* Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, 16.

41. *See* Stephen H. Dorsey, 49 T.C. 606, 629 n.3 (1968); *cf.* Slater v. Commissioner, 356 F.2d 668 (10th Cir. 1966).

42. Rev. Rul. 58-402, 1968-2 CUM. BULL. 15. *See also* Krane, *Income of the Cash Basis Taxpayer: Tax Now or Later?*, 46 TAXES 845, 851 (1968).

43. Rev. Rul. 68-194, 1968-1 CUM. BULL. 87, 88; *cf.* Rev. Rul. 60-31, 1960-1 CUM. BULL. 174. *See also* Stephen H. Dorsey, 49 T.C. 606 (1968); Krane, *supra* note 42, at 851 & n.40.

play an important role in his ability to select and justify his method of reporting gain from a sale.[44]

METHODS OF REPORTING GAIN

As a general rule, the cash basis taxpayer must report income in the year of receipt.[45] When a deferred payment sale of property is involved, however, the taxpayer is accorded several other options; although each of these options has its own distinct variations and characteristics, the problems of valuation pervade each. There are three predominant methods by which gain may be reported: the closed method, the installment method, or the open method. Under the closed method[46] the transaction is deemed completed in the year of sale.[47] This means that a valuation of the purchaser's obligation has been made, either voluntarily by the taxpayer or at the insistence of the Service. The determined value is includable in the amount realized in the year of sale and therefore will be included in the computation of gain.[48] The entire amount of gain so determined will be capital in nature.[49]

If real property is sold on a deferred payment plan,[50] and no more than thirty per cent[51] of the selling price is received in the year of sale, the taxpayer may elect to report gain[52] by the installment method of section 453.[53] His

44. *Cf.* Warren Jones Co., 60 T.C. No. 70 (Aug. 7, 1973). This commentary assumes the cash basis taxpayer desires maximum deferral of taxable gain or, at the very least, deferral of gain until payments in cash are received from the buyer.

45. TREAS. REG. §1.451-1(a). While the scope of this commentary does not permit treatment of the subject, the taxpayer should be aware of the consequences of the "constructive receipt" doctrine. This doctrine is applied where the taxpayer is presently entitled to the immediate possession of money, and his failure to receive it in cash is due entirely to his own volition. *See generally* 2 J. MERTENS, *supra* note 12, §§10.01-.18; Schlossberg, *supra* note 12.

46. This method is also known as the "deferred-payment method." TREAS. REG. §1.453-4(b)(2). Closed transactions may also be reported under the installment method if they meet the requirements of INT. REV. CODE OF 1954, §453. *See* note 36 *supra.*

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

48. INT. REV. CODE OF 1954, §1001; TREAS. REG. §1.446-1(c)(1)(i); *see* 2 J. MERTENS, *supra* note 12, §11.01.

49. This commentary assumes sale of a capital asset held for a period sufficient to qualify for long-term capital gain treatment. It is not concerned with such transactions as dealer sales of real estate. For treatment of the discount when payment is received from the buyer, see text accompanying notes 75-122 *infra.*

50. Section 453 also applies to sales of property other than real estate. INT. REV. CODE OF 1954, §§453(a)-(b). *But see* note 49 *supra.*

51. INT. REV. CODE OF 1954, §453(b)(2). *See generally* Kearne, *Installment Reporting for Income Tax Purposes,* 9 A.B.A. NOTES 29 (1972) (outlining requirements for installment reporting, with citations); Voegelin, *supra* note 1 (presenting an attorney's "how-to-do" approach with examples and suggestions). It should be noted that under this method the obligations *of the purchaser* will generally not be considered in computing the amount of payments received in the year of sale. INT. REV. CODE OF 1954, §453(b)(2)(A)(ii). *But see* TREAS. REG. §1.453-3.

52. Section 453 does not apply to losses. Rev. Rul. 70-430, 1970-2 CUM. BULL. 51.

53. For a suggested method of electing the installment method, see TREAS. REG. §1.453-8(b).

election to use the installment method must be indicated on his return.[54] As this method has received specific statutory sanction it offers the taxpayer the safest way of deferring gain from the sale of property.[55] By allowing a proportionate amount of each subsequent payment to be reported as gain,[56] section 453 effectively allows tax liability to follow as a function of cash flow from the sale. Nevertheless, there may be situations in which installment reporting is not available to the taxpayer.[57] In these circumstances the taxpayer's only hope of deferring gain will be if the obligation is found to have no ascertainable value,[58] and he is allowed to report under the open method.[59]

The open method[60] allows recognition of gain to be postponed until the taxpayer has recovered the adjusted basis of the property sold.[61] As deferred payments are received they are applied to reduce the adjusted basis.[62] Payments received in excess of adjusted basis are recognizable as gain.[63] The original character of that gain remains as if it had been realized during the year of sale.[64] Because the obligation is incapable of valuation, total gain cannot be computed,[65] and the transaction cannot be closed in the year of sale. The sale is viewed as a continuing transaction,[66] and gain is determined as payments are received by the seller.

Separation and identification of the individual methods does not mean that a taxpayer can arbitrarily select the method he will use. To some extent a taxpayer can structure a given transaction to fit more easily into one or another of the methods.[67] He has no guarantee, however, that his choice will be

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54. *Id.* While earlier cases were very strict about this requirement, *e.g.*, John Harper, 54 T.C. 1121 (1970); W.A. & Lorrene B. Ireland, 32 T.C. 994 (1959), the Treasury now allows a retroactive election where the taxpayer has acted in good faith. Rev. Rul. 65-297, 1965-2 CUM. BULL. 152. The Tax Court and the Service have also acknowledged that a taxpayer reporting on another method could, on the same return, make an election (claimed alternatively) to use the installment method, if it should ultimately be determined that the taxpayer was not entitled to use the other method of reporting. Warren Jones Co. 60 T.C. No. 70 (Aug. 7, 1973).

55. INT. REV. CODE OF 1954, §§453(a)(1), -(d)(1).

56. INT. REV. CODE OF 1954, §453(d)(1); TREAS. REG. §1.453-1(b).

57. For example, the transaction may not comply with the 30% limitation on payments in the year of sale. Generally, a taxpayer can construct a deal to qualify. See authorities cited note 51 *supra*. This commentary will focus on those situations where the installment method is not available.

58. See text accompanying notes 40-44 *supra*.

59. See text accompanying notes 88-112 *infra*.

60. This method is also known as the "cost-recovery method." Burnet v. Logan, 283 U.S. 404 (1931).

61. Burnet v. Logan, 283 U.S. 404 (1931).

62. TREAS. REG. §1.453-6(a)(2).

63. *Id.*

64. Westover v. Smith, 173 F.2d 90 (9th Cir. 1949); *see* Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948), *construing* Burnet v. Logan, 283 U.S. 404 (1931).

65. *See* Stephen H. Dorsey, 49 T.C. 606 (1968).

66. *See* cases cited note 64 *supra*. This allows satisfaction of the sale or exchange requirement; text accompanying notes 85-87 *infra*.

67. For example, the taxpayer might take only a 20% downpayment to ensure compliance with the 30% limitation of §453. He might accept a nonassignable land contract in

upheld should the Service decide to challenge the method of reporting.[68] In any event the taxpayer should be aware of the type of evidence and arguments that may support his valuation position.[69]

OVERCOMING THE PRESUMPTIONS AGAINST THE TAXPAYER

Closed Method

The choice of form of the purchaser's obligation may operate to close a transaction. If the obligation has a fixed face amount due, the ascertainable value will necessarily be some percentage of that amount. These are called "fixed price" obligations.[70] On the other hand, certain obligations, such as an obligation wherein the purchaser agrees to pay a certain percentage of profits over a period of time, will have no face amount, and the total amount to be paid will be determined by future events. These are called "contingent" obligations,[71] and any ascertainable value will necessarily represent only a reasonable estimate[72] of the present worth of such contingent payments.[73] In either case, the effect of closing the transaction by valuation is the same: immediate realization of gain under section 1001 and a possible conversion of capital gain into ordinary income. This detrimental conversion generally results if and when subsequent payments by the obligor exceed the determined value of the obligation previously included in the amount realized.[74]

When an obligation is valued, that value becomes the basis of the obligation in the hands of the seller.[75] If a fixed price obligation is valued at 100 per cent of face, any and all gain realized will be taxable in the year of sale at capital gain rates.[76] If a fixed price obligation is valued at less than 100 per

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order to reduce the possibility of valuation (this is a risky way to attempt deferral). See note 1 *supra* for other alternatives open to the taxpayer.

68. For instance, the seller may agree to 20% down and the balance of the purchase price secured by what the seller believes to be a contract with no ascertainable value (because, for example, of the poor financial condition of the purchaser). He then reports on the open method. If the Commissioner challenges this method, and is successful in demanding that the obligation be valued at 50% of face, thereby closing the transaction, the taxpayer will find he has been subjected to a substantial change in tax position. He will no longer be allowed to report on the open method; he will be ineligible for the installment method (selling price = downpayment plus fair market value of purchaser's obligation — (.20 + .50 X .80) = 60% of the *contract* price. And, .20 (downpayment)/.60(§453 selling price) = 33.3% in payments in the year of sale, which would exceed the 30% limitation). Additionally, all payments in excess of 60% of the *contract* price will be taxed at ordinary rates. The 60% will be includable in the amount realized in the year of sale.

69. See note 57 *supra.*

70. *See generally* Cain, *supra* note 12, at 128-29.

71. *Id.*

72. See text accompanying note 43 *supra.*

73. Transactions involving this type of obligation will rarely be closed. Stephen H. Dorsey, 49 T.C. 606, 628-29 (1968).

74. See cases cited notes 79-80 *infra.*

75. *Id.*

76. *E.g.,* Gertrude H. Sweet, 8 B.T.A. 404 (1927); W. B. Geary, 6 B.T.A. 1109 (1927), *modified,* 30 F.2d 1011 (4th Cir. 1928). *But see* note 49 *supra.*

cent of face, the "discount" (the difference between the face and the valuation) is not realized in the year of sale.[77] If the discount is received at a later time it will result in additional gain, which will be taxed at ordinary rather than capital gain rates.[78] Historically, such discount gains were considered to be realized prorata as payments were received, the remaining portion of each payment being considered a return of the taxpayer's basis in the obligation.[79] Some of the more recent cases, however, indicate that the taxpayer is not considered to have received any discount until his entire basis in the obligation is recovered.[80] This latter approach seems to better recognize the whole notion of discounts being indicative of some element of risk and the possibility that the entire face amount may never be realized. Otherwise, there would be no reason to discount the obligation in the first instance.

The contingent obligation is by definition speculative in nature. Very few of these obligations will be subject to valuation, as there probably will be no *reasonable* grounds on which to base such an estimate.[81] Perhaps where there is an "[e]stablished industry with sufficient criteria for ascertaining fair market value,"[82] valuation will be required. This concept has not received much support in real estate transaction law.[83] If such obligations are valued, however, the taxpayer will be allowed to recover his basis before realizing ordinary income on the subsequent payments.[84]

The character conversion of discount payments from capital gain to ordinary income is a result of dogmatic application of statutory language, which states that capital gain can be recognized only where there has been a "sale or exchange"[85] of property. Under the closed method, the only sale or exchange is deemed to have taken place at the time the agreement was completed and the obligations received and valued by the taxpayer. All subsequent payments by the purchaser are considered to be in satisfaction of a debt and not a sale or exchange transaction.[86] The mere act of valuation should not result in conversion of capital gain into ordinary income.[87] Where reasonable

77. *E.g.*, Robert B. Riss, 23 CCH Tax Ct. Mem. ¶27,061 (1964); Rapid Transit Land Sales Co., 20 B.T.A. 608 (1930).

78. *E.g.*, Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962); Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952).

79. *E.g.*, Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962); Shafpa Realty Corp., 8 B.T.A. 283 (1927).

80. *E.g.*, Phillips v. Frank, 295 F.2d 629 (9th Cir. 1961); Joe M. Smith, 48 T.C. 872 (1967).

81. See text accompanying notes 34-44 *supra*.

82. Stephen H. Dorsey, 49 T.C. 606, 630 (1968).

83. *Id.; cf.* Warren Jones Co., 60 T.C. No. 70 (Aug. 7, 1973), and cases cited therein. *But see* Cain, *supra* note 12, at 143-44 n.88.

84. See cases cited notes 79-80 *supra*.

85. *See* INT. REV. CODE OF 1954, §§1001(c), 1002, 1222(3).

86. Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962). Note that proportionate recovery of basis and discount has the effect of accelerating the inclusion of ordinary income. Walter H. Potter, 44 T.C. 159 (1965).

87. This is particularly true in light of the fact that under §453 deferral is possible while maintaining the original nature of any gain. The Commissioner's approach to valuation seems to add a conversion and acceleration penalty in derogation of the general intent of Congress as expressed by §453. If Congress had intended §453 to be the exclusive method of deferred reporting, it could have so provided in a single sentence.

valuation cannot be had, this conversion will not result, and the taxpayer may report on the open method.

Open Method

Because of the rationale of the open method many cases in this area concern obligations received in a sale for an indeterminate price.[88] In addition to contingencies involving the total amount[89] to be paid, there may be doubt as to the probability of payment[90] or the time of payment.[91]

The leading case of *Burnet v. Logan*[92] involved an agreement that reflected all three types of contingencies.[93] The Supreme Court held that the purchaser's obligation had no ascertainable value and that the taxpayer could report the transaction on the open method.[94] The doctrine of *Burnet v. Logan* is not, however, limited to sales for an indeterminate amount. Even in sales for a fixed price, doubt as to probability of payment, time of payment, or other valuation factors may allow open transaction treatment.

The Ninth Circuit has stated that transactions "[c]an [not] be treated as closed simply because the purchasers are legally bound to pay a fixed sum in installments."[95] The court noted that the elements of risk and uncertainty are always material factors in valuation.[96] While the significance of these factors is acknowledged in commercial trade, as reflected by the amount of discount on certain obligations, this economic reality apparently goes unrecognized in the tax area.[97] The Commissioner continues to insist that obligations are the equivalent of cash to the extent of their ascertainable value.[98] Courts have required that even obligations with substantially discounted values be included in the amount realized by the seller.[99] This approach ignores the direct cor-

88. See text accompanying notes 71-72 *supra*.

89. See notes 92-93 *infra*.

90. An example is a promise to pay an amount based on the profits of a new business. See Stephen H. Dorsey, 49 T.C. 606 (1968).

91. An example is an agreement to pay upon the happening of some fortuitous event. *Id. See generally* Cain, *supra* note 12.

92. 283 U.S. 404 (1931).

93. The taxpayer had sold her stock in a mining company in return for a promise to pay sixty cents a ton for ore mined in the future. The Court noted that the agreement did not require the purchaser to continue mining operations, and thus there was no way the taxpayer could determine how much ore would in fact be mined. The ultimate amount that might be received by the seller was dependent upon contingent future production. *Id.* at 410-13.

94. *Id.* at 413.

95. Willhoit v. Commissioner, 308 F.2d 259, 263-64 (9th Cir. 1962).

96. The court related these factors to future payments. *Id.* at 264.

97. *See* Rapid Transit Land Sales Co., 20 B.T.A. 608 (1930).

98. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

99. Robert B. Riss, 23 CCH Tax Ct. Mem. ¶27.061 (1964) (note valued at 78% of face includable in amount realized); Herbert Kaufman, 23 CCH Tax Ct. Mem. ¶26,786 (1964) (installment contract includable at 70% of face); Homes Beautiful, Inc., 6 CCH Tax Ct. Mem. ¶15,873 (1947) (notes includable at 35% of face); Rapid Transit Land Sales Co., 20 B.T.A. 608 (1930) (installment land contract includable at 65% of face); August Belmont Hotel Co., 18 B.T.A. 643 (1930), *acquiesced in*, X-1 CUM. BULL. 5 (1931) (mortgages includable at 60% of face); Gertrude H. Sweet, 8 B.T.A. 404 (1927) (contract includable at 75% of face).

relation between risk and commercial discount; as risk of nonpayment increases, the discount required increases.[100] Courts should ask when the amount of risk or discount is sufficient to warrant a finding of no ascertainable value. It appears that point is reached whenever it becomes impossible to find a value at which a "willing" vendor would sell.[101] A movement toward this line of reasoning is reflected in a recent Tax Court decision.

In *Warren Jones Co.*[102] a taxpayer sold certain real estate with an adjusted basis of $62,000[103] for a price of $153,000.[104] He received $20,000 cash as a downpayment, and the $133,000 balance was to be paid in contractual installments of $1,000 per month for fifteen years.[105] The contract was of a type regularly employed in the area and there was no other evidence of indebtedness. There was no question as to the solvency of the purchaser of the property. In fact, the contract could have been sold to a financial institution for $118,000; but, of that amount, $41,000 would have been held in escrow.[106] In effect, the seller would have received $77,000 cash upon the sale of the contract.[107]

The Tax Court held the contract was not the equivalent of cash and did not constitute "property (other than money)" under section 1001(b) as it could be sold only at a discount of almost 50 per cent of face value.[108] The court stated that the taxpayer need not include the discounted value in the amount realized, noting that it was perhaps "[i]mproper to speak in terms of 'fair market value' (since no one would willingly sell *this* contract for such a highly discounted figure) or 'readily marketable' (since the case of marketability [rested] upon the cheap selling price)."[109] There was also a recognition that all subsequent payments above the $77,000 discounted value would be taxed at ordinary income rates.[110] Distaste for this inverse conversion may have played a significant part in the decision. The *Jones* court adopted a discount test to be used on a case-by-case basis for valuation purposes; any discount on obligations should not be substantially greater than the generally prevailing premium for the use of money.[111] This test is a reasonable and workable solution to the valuation problem.[112]

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100. The discount will generally also increase as the *time* to full payoff increases.

101. *See* Warren Jones Co., 60 T.C. No. 70 (Aug. 7, 1973).

102. 60 T.C. No. 70 (Aug. 7, 1973).

103. The figures used in the text are approximations.

104. 60 T.C. No. 70 (Aug. 7, 1973).

105. *Id.*

106. The court noted that the seller would not have been in constructive receipt of this amount, but suggested that had there been constructive receipt the case might have gone the other way. *Id.*

107. *Id.*

108. *Id.* n.3.

109. *Id.*

110. *Id.*

111. *Id. See also* Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961) (implying use of a similar test).

112. See TREAS. REG. §§1.453-3(e)(1)-(2), where the Treasury recognizes that dicounts may have an impact on the realization of income. This Regulation states a "substantial discount

Warren Jones Co. is not the only case in which the Tax Court has resisted valuation of obligations that would convert capital gain into ordinary income solely because of the vagaries of the sale or exchange requirement.[113] Examination of the purpose behind the Commissioner's view that all obligations are to be valued in the year of sale lends support to the court's stand. The Commissioner's viewpoint is set out in Revenue Ruling 58-402.[114] That ruling concerned contracts to receive indefinite amounts, such as those received in exchange for stock in liquidation of a corporation. In the hands of the corporation, payments on such contracts would have resulted in ordinary income; in the hands of the shareholder, however, such payments would result in capital gain.[115] Addressing himself to these transmutation situations, the Commissioner stated that valuation was "[n]ecessary . . . in order to prevent escape from the ordinary income tax by converting income payments into capital gains; to ascertain the value of the property contract received by the seller-shareholder in the prior sale or exchange and to close that transaction . . . ."[116] His concern was not with deferral of capital gain but with conversion of ordinary income from third-party contracts into capital gain. Thus, where the original character of gain realized would have been capital in a cash transaction, it seems patently unfair to allow a backwards conversion to ordinary income simply because the sale was made in a deferred payment method. The mad rush to value obligations and to close transactions goes far beyond the limited purpose stated in the ruling, and ignores the true character of the original transaction.[117]

Another policy argument may be made in favor of retention of capital gains treatment for deferred payments. In *Arrowsmith v. Commissioner*[118] the taxpayers, corporate shareholders, caused a liquidation of their corporation and reported gain realized as capital gain.[119] In a later year the taxpayers were forced to pay a judgment rendered against the corporation. The taxpayers claimed an ordinary loss for the payment, but the Supreme Court held it to be a capital loss. The Court reasoned that liability was imposed upon the taxpayers in their capacity as transferees in the liquidating distribution, a capital

rule" of 80%, to the effect that obligations valued at less than 80% of face will no longer be considered convertible securities.

113. *See, e.g.*, Stephen H. Dorsey, 49 T.C. 606 (1968).

114. 1958-2 CUM. BULL. 15.

115. A dissolution was regarded as a sale or exchange and, under the doctrine of Burnet v. Logan, 283 U.S. 404 (1931) as interpreted by Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948), that sale or exchange was considered to continue from the original sale as an open transaction. *Id.* Note that under INT. REV. CODE OF 1954, §1232, certain bonds and other evidences of indebtedness may statutorily satisfy the sale or exchange requirement with respect to retirement payments on the obligation. Thus, these would qualify for continued capital gains treatment as payments were received.

116. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, 17.

117. *See generally* Schlossberg, *supra* note 12.

118. 344 U.S. 6 (1952).

119. *Id.* at 7. The taxpayer reported under Int. Rev. Code of 1939, §115(c) (now INT. REV. CODE OF 1954, §331(a)), which accords complete liquidations full exchange treatment. See note 115 *supra*.

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transaction, and that payment was "related to" the earlier transaction.[120] Apparently the "relation back" doctrine of *Arrowsmith* has been applied only to recovery and restoration situations;[121] none of the cases on deferred payment sales even discuss the doctrine.[122]

Mr. Justice Jackson, in his dissent in *Arrowsmith,* implied that the doctrine could be used by a taxpayer as well as by the Service. If the Commissioner can look to a prior year in order to maximize tax receipts resulting from related transactions, there seems to be no logical reason for denying a taxpayer the same opportunity in order to minimize his tax liability. In other words, a taxpayer might successfully argue that the transactional approach of *Arrowsmith* allows gain received subsequent to the year of sale to be characterized by the nature of the original sale.

CONCLUSION

For the unwary landowner, the deferred payment sale of real property may result in unanticipated and unpleasant tax consequences. The cash basis taxpayer expects to match tax liability with income items. Dogmatic and unrealistic valuation of a purchaser's obligations combined with formalistic and relentless application of a sale or exchange requirement by the courts and the Service have complicated the seller's problems. Yet, with advance planning, a taxpayer may overcome many of the hurdles in his path.

Generally, a taxpayer should try to construct a sale to qualify for reporting under the installment method of section 453. In those situations where this method is not used, however, the seller will still want to preserve the capital nature and to defer the tax incidence of any gain. The substantial discount test of *Warren Jones Co.* will provide partial relief from the unwarranted tax consequences of economically blind valuation. Courts should adopt this test in order to avoid further extension of valuation beyond the Commissioner's original purpose. Finally, the taxpayer should be allowed to use the doctrine of *Arrowsmith* to characterize any gain subsequently realized on receipt of deferred payments. Courts have sanctioned the Commissioner's use of this doctrine to avoid the sale or exchange requirement and to violate the integrity of the taxable year in order to maximize tax receipts. Equity and common sense demand that taxpayers be afforded the same opportunity in order to minimize tax liability.

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120. 344 U.S. at 6.

121. *See generally* J. CHOMMIE, FEDERAL INCOME TAXATION §118, at 349, 350 n.5 (1973).

122. See Krane, *supra* note 42, at 852 & n.45.