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Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980

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When a taxpayer sells property for a promise of future payment, it is normally to his advantage to defer any gain realized on the sale. Section 453 of the Internal Revenue Code[1] permits a seller of property in an installment sale to postpone recognition of gain until he has received payments from the purchaser, and then he need only recognize gain ratably as payments are received.

In some instances, however, a seller may seek even greater deferral of gain than is provided by section 453 under so-called "open transaction" treatment. This article deals with the circumstances under which open transaction treatment may be achieved after the Installment Sales Revision Act of 1980.[2] It clearly continues to be available under the theory of *Burnet v. Logan*[3] to situations in which the value of the consideration received by the seller cannot be determined. The Act, its legislative history and the Treasury's temporary regulations support this result. It also should continue to be available for a cash method seller who receives a purchaser's promise of future payment the value of which can be determined, but which is not the equivalent of cash. The Act supports that result. The Senate Finance and House Ways and Means Committee reports on the Act and the Treasury's temporary regulations, however, take a contrary position.

Part I of this article examines the tax consequences of deferred payment sales and compares the possible ways in which deferred payment sales may be reported. Part II discusses open transaction treatment under the theory of *Burnet v. Logan.* Part III deals with the continuing possibility under the Installment Sales Act of open transaction treatment for deferred payment sales by a seller using the cash method of accounting. It discusses the theoretical basis and case law support for permitting open transaction treat-

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[1] I.R.C. § 453(a), (c).

[2] The Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980) [hereinafter cited as the Installment Sales Act].

[3] 283 U.S. 404, 412-413 (1931) (when amount of future payments not ascertainable, taxpayer may apportion payments to return of capital first and then to profit). The procedure used in *Burnet v. Logan* is called the cost recovery method.

ment based solely on the cash method of accounting and argues that despite contrary indications in the legislative history of the Installment Sales Act, the statutory language itself requires continuation of the theory. Part IV examines the application of the theory for open transaction treatment dealt with in Part II to fixed sum financial obligations. It argues that the theory applied in *Burnet v. Logan* should have no application to those situations and that judicial acceptance of its application in such cases has been mistaken. Finally, Part V points out the new considerations which taxpayers must weigh under the Installment Sales Act in seeking open transaction treatment rather than accepting statutory installment method treatment under section 453.

I. THE TAX CONSEQUENCES OF DEFERRED PAYMENT SALES

A taxpayer who sells property for consideration, the value of which exceeds his basis in the property, realizes gain on the sale to the extent of the excess.[4] In general, when a taxpayer sells property at a gain, he realizes and is required to report his gain as income in the year of the transaction.[5] If, however, the taxpayer receives a promise of future payment in exchange for the property, unless he elects otherwise, he must postpone realization of gain until he receives those future payments.[6]

Under section 453, as amended by the Installment Sales Act, all sales of real property and non-dealer sales of personal property in which at least one payment is to be received by the seller of the real or personal property after the close of the taxable year of the transaction must be reported under the installment method unless the seller elects not to have the installment method apply.[7] Installment sales by dealers in personal property are exclud-

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[4] Section 61(a)(3) provides that gross income includes gain derived from dealings in property. Section 1001 sets forth the method for determining gain or loss from the sale of property. Section 1001(a) provides that gain from the sale or other disposition of property shall be the excess of the amount realized from the sale over the taxpayer's adjusted basis for the property. Amount realized is defined in section 1001(b) as the sum of any money received on the sale of property, plus the fair market value of any property (other than money) received on the sale. Adjusted basis for property is defined under section 1012 as the taxpayer's cost of such property as adjusted under the rules provided in section 1016.

[5] I.R.C. § 1001(c). There are, however, exceptions in the Code to the rule that gains or losses realized must be recognized in the same year. *See, e.g.*, I.R.C. §§ 351, 354, 721, 1031, 1033.

[6] I.R.C. § 453(a), (c).

[7] I.R.C. § 453(a), (b), (d)(1). In making the installment method the general rule for reporting gain from deferred payment sales, Congress also eliminated three technical requirements that had restricted use of the method. First, the Act eliminated the initial payment limitation which prohibited use of the installment method if payments received on the sale in the year of the sale exceeded 30% of the selling price. Second, the Act eliminated the two-payment rule which prevented a seller from electing installment method treatment if the total purchase price was payable in a single year, even though that year was subsequent to the year of sale. Third, the Act eliminated the requirement that installment method treatment could not be available to a casual sale of personal property unless the selling price exceeded $1,000. I.R.C. § 453(b)(1), (b)(2).

ed from the definition of installment sale, but may, however, qualify for installment treatment under section 453A.[8]

A. *Sale for Fixed Future Payments.*

1. *Installment Method.*

Under the installment method, when a seller sells property at a gain for cash plus the purchaser's promise to pay cash in the future, he reports that gain ratably as he collects the proceeds of the sale, and a fixed proportion of each payment is reported as gain in the year the payment is received.[9] The fixed proportion is equal to the ratio of the seller's gross profit, realized or to be realized when payment is completed, to the total contract price.[10] In essence, therefore, if appreciated property is sold under the installment method, a portion of each payment received by the seller, including payments received in the year of sale, will constitute and be reportable as gain on the sale, and a portion will represent recovery of the seller's basis.[11]

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[8] I.R.C. § 453(b). The scope of this discussion will be limited to installment sales under section 453. Therefore, unless otherwise stated, the term "seller" as used in this article refers to a casual seller of personal property or a seller of real property.

[9] I.R.C. § 453(c). Section 453 applies to gain only. Accordingly, the installment method may not be used to spread losses. *See* Sacks v. Burnet, 66 F.2d 223, 224 (D.C. Cir. 1933); Martin v. Commissioner, 61 F.2d 942, 944 (2d Cir. 1932) (spreading loss in installment sale of stock disallowed); Rev. Rul. 70-430, 1970-2 C.B. 51 (loss from installment sale of corporate assets must be deducted from gross income in taxable year sale made).

[10] I.R.C. § 453(c). Gross profit is determined by first computing the selling price, or total consideration received by the seller, including liabilities assumed or to which the property is taken subject. Temp. Reg. § 15A.453-1(b)(2)(ii), 46 Fed. Reg. 10,709 (Feb. 4, 1981). The buyer's promise of future payment at its face amount, regardless of the fair market value of the promise, and the fair market value of all other property, must be included. The selling price is then reduced by the seller's adjusted basis in the property and by commissions and expenses of sale. Temporary Regulation section 15A.453-1(b)(2)(ii), 46 Fed. Reg. 10,709 (Feb. 4, 1981), computationally adds commissions and other selling expenses to the basis of the property, rather than viewing them as a separate reduction from selling price in arriving at gross profit.

Total contract price is the selling price reduced, in the case of property sold to a buyer who assumes or takes subject to a mortgage, by the amount of the mortgage indebtedness. A special rule applies when the amount of mortgage liability exceeds the seller's basis in the property. In such a case, only the excess of the liability over the seller's basis (adjusted to include commissions and other selling expenses) is included in the total contract price. Temp. Reg. § 15A.453-1(b)(2)(iii), 46 Fed. Reg. 10,709 (Feb. 4, 1981). *See also* Burnet v. S&L Bldg. Corp., 288 U.S. 406, 414 (1933). This special rule in the temporary regulations represents a departure from the previous Service position under Regulations section 1.453-4(c), which excluded selling expenses from the seller's basis in the property for purposes of determining the amount included in the total contract price by reason of the mortgage liability in excess of the basis of the property. The temporary regulations issued under section 453 were also issued as a Notice of Proposed Rulemaking.

[11] This article will not discuss the tax treatment of any unstated interest element in installment payments. The temporary regulations make treatment of installment payments subject to section 483 of the Code. *See* Temp. Reg. §15A.453-1(b)(2)(ii), -1(b)(5) Ex. 4, 46 Fed. Reg. 10,709, 10,711 (Feb. 4, 1981). Section 483 which deals with imputed interest, is designed to prevent a seller from transforming interest income into capital gains. When deferred payments are received under a contract for sale that makes no provision for interest or provides for an interest rate of less than six percent, a portion of the deferred payment is treated as interest and the balance as purchase price payment. *See* I.R.C. § 483; Reg. § 1.483-1(d)(ii). The portion

When the buyer's obligation has been fully satisfied, the seller will have recovered his entire basis in the property sold and will have reported his entire gain during the years in which he received payments. Further, since all deferred payments are accounted for under this method, all gain will be capital gain[12] if the transaction qualifies for capital gains treatment.

2. *Closed Transaction Treatment.*

A seller may elect, under section 453(d), not to have the installment method apply to his transaction, even though he is to receive payments in the future. In that case, if the seller is a cash method taxpayer, he must value the purchaser's promise and include that value as part of the amount realized in determining his immediately recognizable gain on the sale.[13] If the promissory notes are valued at less than their face amount, the seller may ultimately receive more than the amount included in his income for the year of the sale. Such additional amounts, sometimes referred to as collection gain, would be includible upon receipt in the seller's income as ordinary income, since these additional amounts would not have been received on the sale of a capital asset.[14] This method of reporting gain from sales is often referred to as closed transaction treatment.

Different rules are applicable to accrual method taxpayers. An accrual method taxpayer who elects not to report his sale under the installment method must report his gain by including the face amount of the buyer's promise of future payment, rather than its fair market value, in the amount realized.[15] The entire amount which the seller will ultimately be paid, minus

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constituting interest is determined by imputing a seven percent rate of interest, compounded semi-annually, on the deferred payment. Reg. § 1.483-1(c)(2)(ii)(B). *See also* Temp. Reg. § 15A.453-1(c)(ii), 46 Fed. Reg. 10,712 (Feb. 4, 1981) which provides detailed rules for the application of the imputed interest rules of section 483 to contingent price sales under the installment method.

[12] Interest, stated or imputed, on the installment obligation will, of course, not be classified as capital gain. See note 11 *supra.*

[13] I.R.C. § 1001.

[14] Shafpa Realty Corp. v. Commissioner, 8 B.T.A. 283, 284-85 (1927) (when petitioner sold realty and accepted discounted mortgage note, each payment should be apportioned between gain and recovery of principal). *See also* Tombari v. Commissioner, 299 F.2d 889, 893 (9th Cir. 1962) (in sale of realty not qualifying for installment treatment, portion of each payment received, to extent such portion represented difference between fair market value and face value of contract, taxable as ordinary income), *aff'g* 35 T.C. 250 (1961). In order for income to be characterized as long term capital gain, it must constitute gain from the sale or exchange of a capital asset held for more than one year. Because collection gain represents gain on the receipt of an obligation of future payment, it is not derived from a sale or exchange and therefore cannot qualify for capital gain treatment. There are, however, some circumstances in which collection gain may qualify for capital gain treatment. Under section 1232, for example, when the purchaser is a corporation that has issued "bonds, debentures, notes, or certificates or other evidences of indebtedness that are capital assets in the hands of the [seller]," amounts received by the seller from the corporation in satisfaction of the indebtedness are considered amounts received in exchange therefor. Payments received by the seller more than one year after the transaction should thus be treated as long term capital gain.

[15] Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766-67 (6th Cir. 1968) (face amount

the interest on the obligation, will be reportable as income in the year of the sale.[16] Consequently, all the gain on the sale will be treated as capital gain if the property sold constitutes a capital asset in the hands of the taxpayer, and no collection gain will result.

3. *Open Transaction Treatment.*

A seller may elect out of section 453, however, not to accelerate recognition of gain as under closed transaction treatment, but rather to obtain even greater deferral of gain than is available under the installment method. This exception to the installment method, known as open transaction treatment, is actually two separate exceptions and will be discussed later in this article.[17] In general, open transaction treatment permits a seller to defer recognition of gain on a sale of property until either the cash or consideration other than certain promises of future payment received exceeds his basis in the property. Thus, open transaction treatment is similar to the installment method in that reporting of gain may be deferred until payments are received by the seller. Unlike the installment method which provides for ratable recovery of basis and reporting of gain, open transaction treatment permits the seller to recover his basis completely before reporting any gain on the sale.[18] Payments received after the seller has recovered his basis are then reported entirely as gain in the year or years received.[19] In addition, under open transaction treatment, the character of the seller's gain reporta-

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rather than fair market value of second mortgage notes received on sale to solvent purchasers of personal property not on the installment method were includible in accrual method seller's income); George L. Castner Co., Inc. v. Commissioner, 30 T.C. 1061, 1073 (1958). *But see* C.W. Titus, Inc. v. Commissioner, 33 B.T.A. 928, 936 (1936) (court viewed fair market value rather than face amount of buyer's contractual promise of payment as relevant for determining gain to accrual method seller of oil leases). The treatment of deferred payments in the sale of realty for a taxpayer using the accrual method is less clear. Regulations section 1.453-6(a)(1) provides that if notes are received in deferred payment sales of realty which do not qualify for installment treatment, the fair market value of the notes, rather than the face value, must be used in computing gain. The regulation does not distinguish between cash method and accrual method taxpayers. The Service has argued that Regulations section 1.453-6(a)(1) does not apply to accrual method taxpayers, and there is some case law support for such a position. Rev. Rul. 79-292, 1979-2 C.B. 287; Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. 365, 372 n.4 (1968) (accrual method seller must report as income face amount in restricted savings account received as payment for sale of realty although amounts not withdrawable by seller until sometime in future), *nonacq. on different issue*, 1968-2 C.B. 3. This position has been criticized. *See* Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 471, 557 n.259 (1975) (suggesting *Western Oaks* incorrectly decided on this point). Promulgation of Temporary Regulation section 15A.453-1(d)(2)(iii) indicates that the Treasury intends to remove this issue from controversy by providing that the rule stated in the text will be applicable to all sales by accrual method taxpayers not under the installment method.

[16] *See* I.R.C. § 1001.

[17] See text accompanying notes 38-70 *infra*.

[18] Burnet v. Logan, 283 U.S. at 412.

[19] *Id.*

ble on deferred payments is determined by the character of the initial transaction.[20] Thus, gain on deferred payments on the sale of property constituting a capital asset in the hands of the seller will be capital gain, and there will be no collection gain to be taxed as ordinary income.[21]

B. *Illustration.*

An illustration is helpful in understanding the tax consequences of these different methods of reporting. Assume that a taxpayer makes a casual sale of personal property, which he has held for more than one year and which constitutes a capital asset, for $10,000, consisting of $2,000 cash and the purchaser's promissory note with a face amount of $8,000. Assume also that his basis in the property is $4,000. Assume, in addition, that the note is payable in equal installments of $2,000 over the next four years, and bears interest at the rate of six percent per annum. Finally, assume that because of risk factors and a stated interest rate below the market rate of interest, the fair market value of the buyer's obligation is only $6,000.

The amount realized by the taxpayer on the sale determined in accordance with the literal language of section 1001(b) would be $8,000: the sum of the cash received ($2,000) and the fair market value of other property received, namely the purchaser's note ($6,000).[22] Accordingly, his realized gain on the sale under section 1001(a) would be $4,000, the excess of the amount realized ($8,000) over his basis ($4,000). As indicated above, depending upon the circumstances, that gain may be reportable in several different ways. For purposes of this illustration, interest will be ignored.

1. *Installment Method.*

If the seller reported the sale under the installment method, the fair market value of the note would be disregarded for purposes of determining the timing of reporting the gain, and the character of the gain. Rather, the taxpayer would report his gain based upon the total amount he would eventually receive on the sale, $10,000. This treatment would obtain regardless of whether the taxpayer is on the cash method or the accrual method of accounting. Under section 453, the taxpayer's gross profit would be the selling price, or total consideration to be received ($10,000), less the taxpayer's adjusted basis in the property sold ($4,000), equaling $6,000. The taxpayer's total contract price would be the selling price ($10,000). The ratio used to determine the portion of each payment reportable as gain is:

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[20] Arrowsmith v. Commissioner, 344 U.S. 6, 8 (1952) (future payments take on character of transaction which gave rise to them).

[21] Section 483, which deals with imputing interest, would still be applicable to future payments if either no interest or insufficient interest were charged on the deferred payments.

[22] I.R.C. § 1001(b).

$$\frac{\text{gross profit}}{\text{total contract price}} = \frac{\$6{,}000}{\$10{,}000} = 60\%$$

Thus, sixty percent of each payment would constitute capital gain and forty percent would constitute return of capital and be nontaxable. This result is set forth in line 1 of Table 1 (on page 613).

2. *Closed Transaction.*

a. Closed Transaction Cash Method. Under the closed transaction method, the entire gain realized would be reportable in the year of sale. The amount of the gain realized, however, depends upon the seller's method of accounting. A cash method taxpayer will include as an amount realized on the sale any cash he receives plus the fair market value of any promissory note he receives. Thus, following this illustration, the amount he realizes on the sale will be \$8,000 (\$2,000 cash plus \$6,000 fair market value of note), and his gain on the sale will be \$4,000 (\$8,000 amount realized less \$4,000 basis). The entire gain of \$4,000 will be reportable as capital gain in the year of the transaction. Collections on the note in excess of its \$6,000 value at the time of receipt, \$2,000 in the aggregate, will not qualify for capital gains treatment since these collection amounts would not have been received on the sale or exchange of a capital asset.[23]

In general, payments received on the purchaser's promissory note will be apportioned between recovery by the taxpayer of his basis in the note, which is the fair market value of the note at the time of receipt, and collection gain. The fraction of each payment that is treated as a return of capital is equal to the ratio of the fair market value of the obligation at the time of sale to the face value of the obligation.[24] Thus, in year 2 and all subsequent years, each \$2,000 payment would be treated as if \$1,500 constituted return of capital on the note, and \$500 constituted ordinary income.[25] This treatment is set forth in line 2(a)(1) of Table 1.

Under some circumstances, however, there is authority to report collection gain on a note, the value of which is less than the face amount, only after basis has been fully recovered rather than pro rata. This cost recovery treatment has been permitted in cases in which the promissory note is speculative.[26]

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[23] If the buyer is a corporation, a different rule would obtain with respect to collection gain under section 1232. See note 14 *supra*.

[24] Darby Investment Corp. v. Commissioner, 315 F.2d 551, 553 (6th Cir. 1963), *aff'g* 37 T.C. 839 (1962); Tombari v. Commissioner, 299 F.2d at 892-93.

[25] Tombari v. Commissioner, 299 F.2d at 892-93; Gilbert v. Commissioner, 6 T.C. 10, 13 (1946); Shafpa Realty Corp. v. Commissioner, 8 B.T.A. at 284-85.

[26] In *Underhill v. Commissioner*, for example, the Tax Court permitted cost recovery and articulated the following test for determining whether cost recovery treatment would be permitted:

> We hold that the ultimate test is whether, at the time of acquisition [of the notes] the person acquiring the obligation (whether by purchase or otherwise) cannot be reason-

If the purchaser's note in the above example was speculative, under the cost recovery approach, each $2,000 payment received in years 2, 3 and 4, respectively, would be treated as recovery of the taxpayer's basis in the note, and the $2,000 payment received in year 5 would be treated as the amount received by the taxpayer in excess of his basis in the note. Under this treatment, gain on the note will be realized only in year 5. As under the general rule, the collection gain will be taxed as ordinary income. This treatment is set forth in line 2(a)(2) of Table 1.

b. Closed Transaction Accrual Method. If the taxpayer in the example were on the accrual method, closed transaction treatment would have resulted in different tax consequences. An accrual method taxpayer who sells property for a note generally must include the face amount of the note, rather than its fair market value, as part of his amount realized on the sale. Thus, the taxpayer on the accrual basis would have an amount realized on the sale of $10,000 ($2,000 cash plus $8,000 face amount of note), and would have realized gain of $6,000 ($10,000 amount realized less $4,000 basis). The entire gain would be reportable as capital gain in the year of the sale, and no collection gain would be realized in any subsequent year. This treatment is set forth in line 2(b) of Table 1.

3. *Open Transaction Treatment.*

Finally, under open transaction treatment, which permits a taxpayer to report gain on a sale only when cash payments are received and to recover his entire basis first before reporting any gain on the transaction, the tax consequences to the seller generally would be more favorable than any of the other methods. In the example, under the open transaction approach, the taxpayer would not report gain until the aggregate amount of the payments he received exceeded his basis, $4,000. Thus, he would report no gain on the $2,000 payment received in the year of the sale or on the $2,000 payment received in year 2. Both of these amounts would represent recovery of the taxpayer's basis in the property sold. In years 3, 4 and 5, however, the entire payment of $2,000 received each year would constitute capital gain. This treatment is set forth in line 3 of Table 1.

> ably certain that he will recover his costs and a major portion of the discount. We believe it is not essential to the ultimate test that the major portion of the discount, which may be reasonably certain to be recovered, be determined precisely. It should be sufficient to make a broad finding in this regard. If the obligation is found to be non-speculative, the taxpayer would then be required to report the payments pro rata upon the total discount.

45 T.C. 489, 495 (1966). The Tax Court listed several factors to be used in determining whether a particular obligation is speculative, including (1) the personal liability of the debtor and his financial position; (2) marketability of the obligation; (3)substantial default of the obligation; (4) the terms of payment and the existence of security for payment and value thereof; and (5) the size of the discount. 45 T.C. at 499. *See also* Liftin v. Commissioner, 36 T.C. 909, 911 (1961), *aff'd*, 317 F.2d 234 (4th Cir. 1963).

TABLE 1

SALE FOR FIXED FUTURE PAYMENTS
AMOUNT OF GAIN RECOGNIZED IN YEARS
PAYMENTS ARE RECEIVED UNDER ALTERNATIVE REPORTING METHODS

Cash Down Payment = $2,000
Face of Note = $8,000, payable $2,000/year for 4 Years
Value of Note in Year 1 = $6,000
Full $8,000 on Note will be Collected from Purchaser

	Year 1—Year of Sale	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Total for 5 Years*
1. Installment Method Cash method and accrual method	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$6,000 cap. gain
2. Closed Transaction a(1)—cash method	$4,000 cap. gain	$500 ord. inc.	$500 ord. inc.	$500 ord. inc.	$500 ord. inc.	$4,000 cap. gain $2000 ord. inc.
a(2)—cash method/ cost recovery	$4,000 cap. gain	$0	$0	$0	$2,000 ord. inc.	$4,000 cap. gain $2,000 ord. inc.
b—accrual method	$6,000 cap. gain	$0	$0	$0	$0	$6,000 cap. gain
3. Open Transaction	$0	$0	$2,000 cap. gain	$2,000 cap. gain	$2,000 cap. gain	$6,000 cap. gain

Both the installment method and open transaction treatment are generally preferable to closed transaction treatment in that they permit deferral of gain realization. In addition, open transaction treatment is generally preferable to the installment method since it allows greater deferral by permitting basis recovery first. Moreover, both the installment method and open transaction treatment are particularly preferable to closed transaction treatment to a cash method taxpayer because they permit the entire profit on the sale to be treated as capital gain instead of requiring the portion representing collection gain to be treated as ordinary income. An accrual basis seller under closed transaction treatment, however, does not have the problem of collection gain; by including as an amount realized the face amount of the note, he has already included in income in the year of sale, the difference between the face and the fair market value of the note, albeit as additional capital gain.

C. *Sale For Contingent Payments.*

1. *Installment Method.*

As a result of the Installment Sales Act, section 453 now permits installment method treatment in cases involving sales for a contingent or uncertain price. Under prior law, several courts had held that the installment method was not available to such sales.[27] Contingent payment sales were treated either as open transactions if they qualified or as closed transactions if they did not.[28]

Section 453, as amended, contemplates that gain on contingent price sales should be reported applying ratable basis recovery, and section 453(i) directs the Secretary of the Treasury to issue legislative regulations to accomplish that rerult.[29] The objective of the regulations will be the substitution of precise rules of basis recovery to deal with virtually all situations in which the consideration to be received by the seller cannot be determined, either because the amount or the timing of the payments is uncertain, or because both are uncertain. The Treasury has indicated that it will attempt to accomplish this objective by fitting each of the situations into a pattern which simulates a fixed payment schedule,[30] and, in temporary regulations,

[27] In re Steen v. United States, 509 F.2d 1398, 1404 (9th Cir. 1975); Gralapp v. United States, 458 F.2d 1158, 1160 (10th Cir. 1972).

[28] *Id.*

[29] Section 453(i)(1) authorizes the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section." More specifically, under section 453(i)(2), the Secretary is directed to prescribe regulations "providing for ratable basis recovery where the gross profit or total contract price (or both) cannot be readily ascertained."

[30] Statement of Harry L. Gutman, Deputy Tax Legislative Counsel, Department of the Treasury, *Hearings on H.R. 3899 before the Subcommittee on Select Revenue Measures, Committee on Ways and Means* [hereinafter cited as Treasury Statement], 96th Cong., 1st Sess. 33

has taken the following positions:[31]

(1) In the case of a sale for a contingent price but with a stated maximum, basis should be recovered by allocating it over the maximum price which may ultimately be paid to the seller.[32]

(2) In the case of a sale for a contingent price with no stated maximum price in which payments are to be made over a specified number of years, basis should generally be allocated equally to each year. This method of basis allocation would not permit loss realization for any year in which the basis allocated to that year exceeded the payments received in that year. Rather, the excess would be added to the seller's remaining basis to be recovered in the next succeeding taxable year. The seller would then be permitted to treat any basis remaining after the expiration of the payment period as a loss in the final year of payment (or earlier if the obligation became worthless).[33]

(3) In the case of a sale for a contingent price with no stated maximum, in which payments are not limited to a specified number of years, basis should be allocated equally over a fifteen-year period. As in the case of contingent price sales in which payments are to be made over a fixed number of years, no loss would be allowed for any year in which the basis allocated to the year exceeded the payments received in that year. In contrast to such sales, however, the excess basis would be allocated equally over the fifteen-year period, rather than simply to the next succeeding year. Even after the expiration of the fifteen-year period, the unrecovered remaining basis would not be allowed as a loss until the future payment obligation had been determined worthless.[34]

The Committee Reports, however, indicate that in some circumstances the regulations were intended to be somewhat more flexible than the above rules indicate. The Committee Reports state that in appropriate cases, when the seller can demonstrate "that receipts will be greater for earlier years of the payment period and then decline for the later years of the payment period," basis recovery should be permitted under an "income forecast type method."[35] In general, an income forecast type method of basis recovery, similar to the income forecast method of depreciation, would permit the

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(1979). The Treasury has issued regulations dealing with a variety of transactions formerly reportable as open and which provide for various schedules of basis recovery for the seller.

[31] Temp. Reg. § 15A.453-1(c), 46 Fed. Reg. 10,711 (Feb. 4, 1981) The Committee Reports, though not so specific in setting forth suggested rules to be included in the Regulations, do not contradict these rules.

[32] Temp. Reg. § 15A.453-1(c)(2), 46 Fed. Reg. 10,712 (Feb. 4, 1981).

[33] Temp. Reg. § 15A.453-1(c)(3), 46 Fed. Reg. 10,714 (Feb. 4, 1981).

[34] Temp. Reg. § 15A.453-1(c)(4), 46 Fed. Reg. 10,714 Feb. 4, 1981).

[35] S. Rep. No. 96-1000, 96th Cong., 2d Sess., 23-24, n.31 and accompanying text (1980); H.R. Rep. No. 96-1042, 96th Cong., 2d Sess. 21, n.29 and accompanying text (1980). The Treasury Statement, at 39, accepts the possibility that a taxpayer may be able to "demonstrate with reasonable certainty from the outset" the amount and timing of payments to be received. In that event, the Secretary should be authorized to permit basis to be allocated equally to each year of the payment contract. In addition, the Report designates sales of movies and sales in

portion of basis to be recovered in any year to be proportional to the ratio which the amount received in that year bears to the total amount expected to be received from the sale. The temporary regulations set forth guidelines under which that method of basis recovery will be available.[36] Further, they provide special basis recovery rules to avoid substantial distortion for situations when the specified rules "substantially or inappropriately defer or accelerate recovery of the taxpayer's basis."[37]

Based upon the Committee Reports and the positions taken by the Treasury in the temporary regulations, one can examine the application of the installment method to a contingent price sale. Assume the taxpayer in the illustration above made the sale for the purchaser's promise to pay him amounts based upon the productivity of the property sold during the year of sale and the succeeding four years. Assume also that over those five years the purchaser made payments, pursuant to his promise, of $2,000 per year.

If the Treasury's position is followed, the seller's basis in the property must be allocated equally over the five years during which payments will be received. Thus, the seller will allocate $800 of his $4,000 basis in the property to each of the five years. As a result, ignoring any imputation of interest under section 483, each $2,000 annual payment will consist of $800 basis recovery and $1,200 capital gain which must be recognized. This result is set forth in line 1(a) of Table 2 (on page 619), and corresponds to the result in the fixed purchase price illustration shown in line 1 of Table 1.

Suppose, however, that the purchaser's agreement is not limited as to time, but rather is a promise to pay the taxpayer amounts based upon the total future productivity of the property sold. In that event, the Treasury position requires the taxpayer's $4,000 basis to be allocated equally over a fifteen-year period, *i.e.*, approximately $267 per year. Thus, if the seller collects $2,000 in each of the first five years and nothing thereafter, ignoring the effect of section 483, each such annual receipt will consist of $267 recovery of basis and $1,733 capital gain which must be recognized. After year 5, however, $2,665 of basis will remain unrecovered. Presumably, a loss

which the annual payments to the seller are a declining percentage of the purchaser's revenues as appropriate cases for basis recovery under the income forecast type method.

[36] Temporary Regulation § 15A.453-1(c)(6), 46 Fed. Reg. 10,715 (Feb. 4, 1981) in general, permits the income forecast method of basis recovery, basis recovery proportional to expected revenues, in situations of contingent price sales of depreciable or depletable property, such as "mineral property, a motion picture film, a television film, or a taped television show," and other property which the Service may specify from time to time.

[37] Temp. Reg. § 15A.453-1(c)(7), 46 Fed. Reg. 10,716 (Feb. 4, 1981). In general, the regulations permit a taxpayer to use an alternative method of basis recovery if he can demonstrate that the alternative method will be a reasonable method of ratable basis recovery and that it will result in twice as fast a rate of basis recovery as would the normal rules. To qualify for an alternative method, however, a taxpayer must receive a ruling from the Service. Temp. Reg. § 15A.453-1(c)(7)(ii), 46 Fed. Reg. 10,716 (Feb. 4, 1981).

Conversely, the regulations permit the Service to require the use of an alternative, slower, method if the normal method is determined to inappropriately accelerate recovery of basis. Temp. Reg. § 15A.453-1(c)(7)(iii), 46 Fed. Reg. 10,716 (Feb. 4, 1981).

in the amount of $2,665 will be allowed in some year, although the temporary regulations do not even guarantee that. This result is noted in line 1(b) of Table 2, assuming the seller can demonstrate that the payment obligation is worthless in year 15.

It seems appropriate at this point to evaluate the approach of statute and the Treasury to basis recovery from a policy perspective. It is problematic whether basis recovery provisions contemplated by the statute could ever accomplish both goals of fairness and ease of administration. The rigid positions taken in the temporary regulations may very well treat some taxpayers unfairly. For example, if a taxpayer sells property based upon income to be derived from the property with no stated maximum price, and if such income is likely to be greatest in the early years, he should be entitled to use more of his basis to offset income in the early years than in later years. But, if the taxpayer is either unable to demonstrate with any precision that his income from the sale will be greater in the earlier years or to bring the transaction under the regulations, which may be the case if the transaction is not the sale of movie or mineral rights, it appears that recourse to income forecast type basis recovery may be foreclosed. As a result, he would be treated harshly under the rule which would allocate basis equally to each year of the payment term or, if there is no fixed term, over fifteen years. The availability of an income forecast type method of basis allocation and special rules to avoid substantial distortion represent attempts to rectify this situation. As a matter of fairness, those rules should be available to all transactions covered under the statute. Under such a system, however, every taxpayer engaged in this type of transaction would be eligible for his own individualized schedule of basis recovery. That result would lead to great uncertainty and, in all probability, substantial amounts of litigation. The Treasury's solution to the inherent policy conflict under the statute was to seek a middle ground. The compromise will lead to substantial complication in the law, that consequence being particularly ironic because the Installment Sales Act was hailed as tax simplification. On the other hand, difficult and complicated problems rarely have simple and uncomplicated solutions.

2. *Open Transaction.*

Under open transaction treatment, by contrast, the seller is permitted to recover his entire basis before recognizing gain, regardless of whether the payment period is five years long or of unlimited duration. Accordingly, the taxpayer in the illustration would report no gain on the first two annual $2,000 payments. Each $2,000 payment would represent recovery of basis. In years 3, 4 and 5, ignoring the effects of section 483, the entire payment of $2,000 received would constitute capital gain. This treatment is set forth in line 2 of Table 2 and corresponds to the result in the fixed purchase price illustration in line 2 of Table 1. It is apparent, therefore, that installment method treatment will permit less deferral of gain, and consequently be less favorable to sellers than open transaction treatment.

D. *Election Out of Installment Method to Obtain Open Transaction Treatment.*

Section 453 automatically triggers installment method treatment on a deferred payment sale by the seller unless the seller elects out. Under section 453(d), this decision must be made in the time and manner prescribed in the regulations to be issued under the statute and is irrevocable without the consent of the Secretary. Nevertheless, in appropriate circumstances, an electing seller may report his transaction as open.

The circumstances in which open transaction treatment is permitted have been the subject of considerable litigation. Despite, or perhaps because of, the many cases grappling with the issue, the law remains in a state of confusion. Moreover, the Installment Sales Act contributes an additional layer of uncertainty. In particular, the Act raises a serious question of whether a sale for a fixed price involving the purchaser's promise of future payment could qualify for open transaction treatment. In order to explore the present boundaries of open transaction treatment, one must first study the development of the law and its statutory underpinnings and then examine section 453, as amended by the Installment Sales Act, and its legislative history.

A taxpayer who sells property for a promise of future payment ordinarily will be required to use closed transaction treatment if he elects out of installment method treatment under section 453. Nonetheless, two possible situations exist in which open transaction treatment may be permitted. First, both cash method and accrual method taxpayers may qualify for open transaction treatment if the purchaser's promise of future payment has no ascertainable fair market value. This first situation is referred to as the no ascertainable value theory. Second, a cash method taxpayer may qualify for open transaction treatment if the purchaser's promise of future payment is not readily marketable by the taxpayer and therefore not equivalent to cash. This second situation is referred to as the cash method theory.

II. OPEN TRANSACTION TREATMENT: THE NO ASCERTAINABLE VALUE THEORY

A. *The Theory.*

An electing seller may treat a transaction as open when the value of the consideration he receives cannot be determined and consequently cannot

TABLE 2

SALE FOR CONTINGENT PRICE
AMOUNT OF GAIN RECOGNIZED IN YEARS
PAYMENTS ARE RECEIVED UNDER ALTERNATIVE REPORTING METHODS

$10,000 will be Collected from Purchaser on Contingent Price Sale at the Rate of $2,000 per year for five years

	Year 1 Year of Sale	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Years 6 Through 14*	*Year 15*	*Total for First 5 Years*	*Total for 15 Years*
1. Installment Method									
a. 5-year payout	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$1,200 cap. gain	$0	$0	$6,000 cap. gain	$6,000 cap. gain
b. Unlimited payout	$1,733 cap. gain	$1,733 cap. gain	$1,733 cap. gain	$1,733 cap. gain	$1,733 cap. gain	$0	$2,665 cap. loss	$8,665 cap. gain	$8,665 cap. gain $2,665 cap. loss
2. Open Transaction	$0	$0	$2,000 cap. gain	$2,000 cap. gain	$2,000 cap. gain	$0	$0	$6,000 cap. gain	$6,000 cap. gain

be included in the amount realized. Open transaction treatment in this situation is referred to in this article as the no ascertainable value theory.[38] The theory applies to both cash method and accrual method taxpayers.

Open transaction treatment under the no ascertainable value theory was approved by the Supreme Court in *Burnet v. Logan*.[39] That case involved a taxpayer who sold stock in a corporation for cash plus the promise of the purchaser to pay her annually $.60 per ton of iron ore removed from a certain mine. The Court held that the promise had "no ascertainable fair market value,"[40] and therefore the taxpayer did not realize gain until she had recovered her basis. In the words of the Supreme Court, "the transaction was not a closed one."[41]

The Service has accepted and continues to accept the no ascertainable value theory after the Installment Sales Act, but takes the position that only in rare and extraordinary cases does the consideration received by the seller have no ascertainable fair market value.[42] These situations arise when the obligation of future payment is not fixed in amount, but rather is contingent on future events.

Fair market value cannot be determined, for example, if the amount of the payor's obligation is based upon receipts generated by the property in question or by other property,[43] or if the amount of future payments is

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[38] The Committee Reports suggest that the no ascertainable value theory should be limited to cases involving sales for a contingent price and should now exclude cases involving sales for a fixed price, even if the collectability of the promise of future payment is speculative. See text accompanying notes 142-56 *infra*.

[39] 283 U.S. 404, 405 (1931).

[40] The Court also held that the promise was not equivalent to cash. *Id.* at 413.

[41] *Id.*

[42] Reg. § 1.1001-1(a); Rev. Rul. 58-402, 1958-2 C.B. 15; Temp. Reg. § 15A.453-1(d)(2)(iii), 46 Fed. Reg 10,718 (Feb. 4, 1981). *See also* Reg. § 1.453-6(a)(2), which deals with deferred payment sales of real property not on the installment method.

[43] Courts have also permitted open transaction treatment when a shareholder receives such a right upon the liquidation of a corporation. For example, Dorsey v. Commissioner, 49 T.C. 606 (1966), involved a taxpayer who received, as a liquidation distribution, the right to future payments to be made under a licensing agreement entered into by the corporation prior to liquidation. Under the licensing agreement, the corporation licensed a patent on automatic pinsetting equipment used in bowling alleys to a third party and was entitled to royalty payments based on the sale or lease by the licensee of pinsetting equipment. The court held that the transaction should be considered open under the doctrine of *Burnet v. Logan* because the value of the rights received by the shareholder of the liquidating corporation depended upon "numerous uncertainties of such a character to make any estimate of the fair market value of those rights sheer surmise and speculation." *Id.* at 629. The principal uncertainties included:

(1) The unsavory past reputation of bowling and its unknown future potential.

(2) The uniqueness of the pinsetting machine as a product, resulting in uncertainty as to its acceptance by the public and bowling proprietors, and expected market problems.

(3) Potential patent infringement suits.

(4) The dependence upon future business decisions made by the licensee to which

based upon the earnings of a corporation.[44] Open transaction treatment under this theory also has been applied when the additional consideration received by the seller is a right to additional property,[45] or when the seller received other kinds of property that could not be valued.[46] The latter situation, however, is indeed rare.[47]

A seller who receives consideration which cannot be valued may nevertheless not be entitled to open transaction treatment under the no ascertainable value theory. If the value of the consideration received cannot be determined, it will be deemed equal to the value of the property sold. Thus, the amount realized by a taxpayer in an exchange of that type, for the purposes of determining gain, is the fair market value of the property transferred by the taxpayer, that value serving as a surrogate for the value of the property received. This principle, articulated by the Supreme Court in *Davis v. United States*,[48] and applied by many lower courts,[49] also appears in the

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the shareholders would be subject with respect to future receipts from the licensee.

Id. at 629-30. *See also* Carter v. Commissioner, 170 F.2d 911, 913 (2d Cir. 1948), (open transaction treatment permitted upon liquidation of corporation to sole shareholder who received contingent rights of future payment owed corporation for work it had performed), *aff'g* 9 T.C. 364 (1947).

[44] United States v. Yerger, 55 F. Supp. 521, 522 (E.D. Pa. 1944).

[45] Bolles v. Commissioner, 69 T.C. 342, 356 (1977).

[46] United States v. State Street Trust Co., 124 F.2d 948, 951 (1st Cir. 1942) (consideration received was highly speculative stock). *See also* Ott v. Commissioner, 15 B.T.A. 867, 869 (1929); Saeger v. Commissioner, 9 B.T.A. 890, 898-99 (1928), *nonacq.*, VII-7 C.B. 51 (1929).

[47] Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954), however, suggests that if neither the consideration received nor the property exchanged has value that can be readily determined, no gain or loss will be realized until the property received on the exchange is ultimately sold.

[48] 370 U.S. 65, 73 (1962). The taxpayer in this landmark case, pursuant to his divorce decree, transferred appreciated property to his spouse in settlement of her marital rights. The Supreme Court of the United States held that the amount of gain realized by the taxpayer on that transfer was the excess of the amount realized by him in the transaction: the value of his spouse's released marital rights over his basis in the property transferred. However, because the marital rights were not susceptible of valuation, they were deemed to be worth the consideration paid for their release, the fair market value of the property transferred.

[49] *See, e.g.*, Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954). In Estate of Wiggins v. Commissioner, 72 T.C. 701 (1979), the contrary result was reached. The Tax Court rejected any reliance on this principle, although the reason for rejection is not clear from the court's opinion. In *Wiggins*, the court held that consideration received by the seller of subdivision lots, in this case the contracts for a deed under which the purchaser was obligated to make payments in a fixed sum to the taxpayer, had no ascertainable fair market value, and that accordingly, the sale of the property could be reported as an open transaction. *Id.* at 712. Application of the *Davis* principle by the Tax Court would have caused the financial obligations of the lot buyers to be assigned a value equal to the fair market value of the lots sold minus other consideration received on the sale. It is still possible that the lots would not have an ascertainable fair market value resulting again in an open transaction treatment. Land appraisals, however, are fairly common and one might speculate that the court would have been indeed reluctant to take the position that a plot of land purchased not for its underlying mineral rights, but rather for its surface residential use, would not be susceptible to valuation.

temporary regulations which correctly take the position that it should apply to contingent price sales[50] not reported on the installment method.

B. *Analysis of the Theory.*

The fair market value of property is not simply determined by the price a particular purchaser would pay for it. Rather, the test of fair market value is phrased in terms of the price that a willing buyer and a willing seller would agree upon, if neither is under compulsion to buy or to sell and both have reasonable knowledge of the relevant facts.[51] Such knowledge of the relevant facts, however, may not be possible under some circumstances. The economic benefit to be derived from the property, for example, may depend upon future events, which may not be predictable. In addition, the character of the property may be so unusual or unique that any attempt at valuation would be mere guesswork.[52] Accordingly, the precise valuation of property may be impossible in some circumstances.

The Supreme Court in *Burnet v. Logan* noted that for purposes of the income tax the valuation question was simply one of timing.[53] Although no accurate valuation of Mrs. Logan's property interest could be made at the time of the transaction, receipt of money or property at a later time would supply a clear value which would be susceptible to taxation. In essence, the issue that confronted the Court in *Burnet v. Logan* was the question of when the income tax on a transaction whose valuation was particularly difficult would be collected.[54] The Court accepted the wait-and-see approach of open transaction treatment urged by the taxpayer and thereby gave its judicial imprimatur to the now well accepted no ascertainable value theory of open transactions.[55]

The justification for the wait-and-see approach approved by the Supreme Court entails two basic considerations: fairness to the seller and the practical difficulties of determining gain any time before the seller's cost has been

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[50] Temp. Reg. § 15A. 453-1(d)(2)(iii), 46 Fed. Reg. 10,718 (Feb. 4, 1981).

[51] Reg. § 20.2031-1(b).

[52] Dorsey v. Commissioner, 49 T.C. at 629 (petitioner's right to receive percentage of profits payments had no ascertainable value; amounts received given capital gains treatment).

[53] 283 U.S. at 404.

[54] In contrast, the Court noted that for estate tax purposes all property must be valued at the time of the decedent's death. That rule was necessary because for purposes of the estate tax there is only one time that the property may be taxed: at the time of the decedent's death. Therefore, property owned by the decedent must be valued regardless of the difficulty of valuation.

[55] Open transaction treatment has also been approved when the amount realized is ascertainable but the adjusted basis of the property exchanged is not. In Inaja Land Co., Ltd. v. Commissioner, 9 T.C. 727 (1947), *acq.*, 1948-1 C.B. 2, for example, the taxpayer sold an easement on his land for $50,000, giving the purchaser a right to divert water onto his land. The court held that because it was impossible to allocate a portion of the taxpayer's $61,000 basis in the land to the easement, the entire $50,000 should be considered a return of capital and the taxpayer's basis in the land should be reduced to $11,000. The transaction thereby gave rise to no gain. *Id.* at 736.

recovered. With respect to fairness, when the determination of how much the seller will receive on the sale is uncertain because the promise of future payment received on the sale is not fixed in amount, the determination of the amount realized by the seller should await actual receipt of payments, because only in this manner will a seller be assured that he will not recognize gain in a transaction in which no gain is ultimately realized.[56] With respect to the practical justification for the approach, even if it were considered fair to the seller to force realization at the time of the sale, as a practical matter one could not determine the amount to be realized until the seller has completely recovered his basis in the property.

On the other hand, the substantial policy objective of annual accounting is accomplished in closing a transaction.[57] Under the annual accounting concept, each year constitutes a separate unit for purposes of determining the tax due for that year. Thus, transactions occurring in a taxable year should be accounted for in that year and tax paid on them should be paid in that year.[58] The annual accounting system comports with generally accepted notions of financial accounting and is fundamental to the practical administration of the tax system.

Judicial determinations regarding the no ascertainable value theory attempt to reconcile the competing goals of transactional fairness and annual accounting. In applying the theory, courts must judge whether the uncertainty involved in the buyer's obligation is sufficient to sustain a determination that the obligation's value cannot be determined. These decisions must be made on the facts and circumstances surrounding the obligation of future payment.

One consequence of open transaction treatment, as discussed earlier is that gain on the transaction (exclusive of interest) is treated as capital gain. Because *Burnet v. Logan* involved tax years prior to the enactment of provisions giving preferential treatment to capital gains, the Supreme Court, in deciding to permit open transaction treatment for the sale, could not consider the additional benefit now derived by taxpayers under this treatment.[59]

It is quite clear from the statute and its legislative history that open transaction treatment under the no ascertainable value theory survives the

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[56] Deferral under the cash method theory, discussed in text accompanying notes 64-157, by contrast, is justified by resort to principles of tax accounting only.

[57] Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364 (1931).

[58] *Id.*

[59] It is interesting to note that the dissenting opinion in Dorsey v. Commissioner, 49 T.C. at 634-35, would have the absence of justification for capital gain treatment under the *Burnet v. Logan* rationale result in requiring immediate realization, even when the consideration received by the seller was subject to great uncertainty. It is difficult to justify this difference in the character of the gain between open and closed transactions. The problem may lie in Code section 1232 which allows collection gain to be treated as capital gain in the case of corporate obligations only.

Installment Sales Act, and a seller may report a qualifying sale as an open transaction by electing out of the installment method.[60] The Treasury, however, in temporary regulations, has taken the position that the scope of transactions qualifying for such treatment has been narrowed under the Act to exclude all fixed amount obligations from open transaction treatment.[61] Further, the temporary regulations warn sellers that purported contingent price sales "will be carefully scrutinized to determine whether a sale in fact has taken place"[62] or whether the transaction constitutes a royalty or similar arrangement.[63]

III. OPEN TRANSACTION TREATMENT: THE CASH METHOD THEORY

A. *In General.*

There is a separate and distinct theory under which a seller can obtain open transaction treatment, in addition to the no ascertainable value theory approved in *Burnet v. Logan*. That separate theory is the cash method theory applicable only to cash method taxpayers. Under the cash method theory, a cash method seller can qualify for open transaction treatment if the purchaser's promise of future payment is not readily marketable, a concept different than having no ascertainable value.

Prior to the adoption of the Installment Sales Act, some courts[64] and commentators[65] demonstrated considerable confusion over the cash method theory. The theory, however, had substantial case law support[66] and theoretical justification, and should have been recognized as controlling authority for permitting open transaction treatment. The confusion over the cash method theory extended to congressional attempts to deal with open transaction treatment in the Installment Sales Act. As a result, the legislative history of amended section 453 is unclear and internally inconsistent. The continued viability of the cash method theory after the adoption of the Installment Sales Act is therefore questionable. Nevertheless, open transaction treatment under the cash method theory should continue to be avail-

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[60] See text accompanying notes 158-74 *infra*; Temp. Reg. § 15A.453-1(d)(iii), 46 Fed. Reg. 10,718 (Feb. 4, 1981).

[61] Temp. Reg. § 15A.453-1(d)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981); text accompanying notes 158-74 *infra*.

[62] Temp. Reg. § 15A.453-1(d)(iii), 46 Fed. Reg. 10,718 (Feb. 4, 1981).

[63] *Id.*

[64] *See* Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Estate of Wiggins v. Commissioner, 72 T.C. 701 (1979); McShain v. Commissioner, 71 T.C. at 998.

[65] *E.g.*, Haley, *The Application of Section 1001 to Deferred Payment Sales of Property*, 28 TAX LAWYER 303 (1975); Llewellyn, *Promises To Pay In The Future—A Modest Proposal For Reform*, 3 U. MIAMI L. REV. 1337, 1340 (1977).

[66] See note 96 *infra*.

able if the seller elects out of the installment method, Treasury Regulations to the contrary notwithstanding.[67] Before dealing with this issue, however, the underpinnings of the cash method theory must be examined.

B. *The Cash Method Theory Prior to the Installment Sales Act.*

1. *Development of the Cash Method Theory.*

The cash method theory recognizes that the amount of income resulting to a taxpayer on a sale of property is determined under section 1001, but holds that the year or years in which such income is properly reportable, as a matter of tax accounting, should be determined with reference to those sections of the Code which deal specifically with tax accounting questions.[68] In general, a cash method taxpayer must include in income in a taxable year all items of gross income received, either actually or constructively, in that year, whether in the form of cash, property, or services.[69] Thus, items of currently reportable income may be received in the form of services and property as well as cash.[70] It is the scope of the term "property" which is critical in determining the timing of income to a cash method taxpayer in a sale for future payments.

a. The Term Property and the Cash Method of Accounting. The term property is defined broadly in property law to include all valuable rights and interests which are subject to ownership. For tax purposes, however, the term has been defined more restrictively. Although under general property law there is no doubt that a right to receive the payment of money in the future is property, such a right for tax purposes generally does not constitute property to a cash method taxpayer.[71] Thus, a cash method taxpayer

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[67] *See* Temp. Reg. § 15A.453-1(d)(2)(i), 46 Fed. Reg. 10,718 (Feb. 4, 1981).

[68] Specifically, Code section 451(a) provides, in part, that any item of gross income shall be included in the gross income of the taxpayer for the taxable year in which it is received unless the amount is properly accounted for in another year under the taxpayer's method of accounting. Section 446 authorizes the taxpayer to compute taxable income under the accounting method he regularly uses in keeping his books.

[69] Reg. § 1.446-1(c)(1)(i). An accrual method taxpayer, by contrast, realizes income when his right to the item becomes fixed and determinable, even though payment is not received until some later date.

[70] Reg. § 1.446-1(a)(3); United States v. Drescher, 179 F.2d 863, 865 (2d Cir.), *cert. denied,* 340 U.S. 821 (1950).

[71] Sometimes courts articulate the principle in terms of a promise of future payment having no tax significance to the seller under the cash method of accounting. *See, e.g.,* Johnston v. Commissioner, 14 T.C. 560, 565 (1950). The promise, it follows, must be ignored for purposes of computing the amount realized by a seller under Code section 1001(b). In essence, that articulation is the same as the position that the promise itself is not property for the cash method taxpayer.

will not realize income from the receipt of a mere promise of future payment.[72] Rather, income is realized by him only upon receipt of the payment itself.[73] This fundamental principle has deep historical roots.[74] It has been recognized in cases dealing with compensation for services,[75] as well as gain from the sale of property.[76] In the latter area, however, the principle has not been uniformly accepted.[77]

The restrictive definition of property for purposes of the cash method is somewhat arbitrary. Certainly it does not exclude all non-cash benefits since from a tax policy standpoint, it would be foolish to allow them to escape inclusion in income for two reasons. First, such a rule would result in tax burdens falling disproportionately on those taxpayers who could not bargain successfully for compensation in kind. Second, such a rule would

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[72] Rev. Rul. 60-31, 1960-1 C.B. 174 (relating to compensation for services). See note 96 *infra* (relating to income from sales). Another circumstance involves compensation for services dealt with in section 83. The regulations under section 83 have specifically defined the term property, for purposes of that section, to exclude promises of future payment. Reg. § 1.83-3(e).

[73] This statement is in contrast with the treatment accorded an accrual basis taxpayer for whom actual payment is generally irrelevant with regard to deferral of realization. *But see* Schlude v. Commissioner, 372 U.S. 128, 136 (1963); Am. Auto. Ass'n v. United States, 367 U.S. 687, 692 (1961); Auto. Club of Michigan v. Commissioner, 353 U.S. 180, 189 (1957) (requiring immediate realization of income on receipt of advance payments).

[74] The Revenue Act of 1916 allowed taxpayers to use the cash method of accounting to compute income. That Act added section 8(g):

> An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed on his income as so returned.

Section 13(d), also enacted by the Revenue Act of 1916, contained corresponding provisions for corporations.

Prior to the 1916 Act, only the accrual basis was permissible. In this connection, section II(g) enacted under the Revenue Act of 1913 had provided, "the tax herein imposed shall be computed upon its entire net income accrued within each preceding calendar year . . . ." J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, 1000 (1st ed. 1938). The report of the House Ways and Means Committee explains the reason for the change:

> The present law requires that the income tax shall be levied on the accrued basis. As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income. H.R. REP. No. 922, 64th Cong., 1st Sess. 4 (1916).

See also Blattmachr, Knapp & Warren, *Accounting Periods and Accounting Methods* 30-32 (1952), *reprinted in* B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 811 (1972).

[75] Rev. Rul. 60-31, 1960-1 C.B. 174.

[76] See text accompanying note 96 *infra* (dealing with relationship of section 1001 to taxpayer's method of accounting).

[77] See text accompanying note 109 *infra* (discussing the Ninth Circuit holding in *Warren Jones).*

create an incentive for taxpayers to barter for non-cash benefits. Because a taxpayer would choose non-cash benefits over cash solely to reduce his tax burden, normal economic choices would be distorted. Therefore, in order to prevent unfairness among taxpayers and distortion of economic choices, the tax law must take non-cash benefits into account, in the form of services or property, as well as cash, in determining a taxpayer's tax liability.

A right to future payment received by the taxpayer is a non-cash benefit and, in traditional legal terms, constitutes property. What, then, distinguishes a right to future payment from other non-cash benefits which are considered property? Neither the current enjoyment of the property nor the ability to earn income from such property can serve as a basis for distinction. The right to future payment may be an interest-bearing obligation and therefore may yield income. The distinction lies only in the policy reasons behind permitting taxpayers to report income on the cash method. These policy reasons are essentially two in number and are steeped in practical considerations.

First, cash method accounting fulfills the need for simplicity in computing income. The cash method of accounting is used by most individual taxpayers and provides a reliable method of computing income without the necessity of resorting to the more sophisticated record-keeping procedures and complicated judgments required under the accrual method. In this connection, cash method accounting relieves a taxpayer from any duty to place a value on the promise of future payment for purposes of computing his income. Rather, he need only await collection of the amounts due under the obligation and report his income, if any, at that time. This procedure comports with an ordinary individual's sense of income because he will typically equate income with receipt of cash.

Second, cash method accounting has the outward appearance of being fair. A cash method taxpayer need pay tax on income only after he has received the item of income.[78] Permitting a cash method taxpayer to defer

[78] In addition, cash method accounting is often an equitable method of tax collection. From a transactional point of view, deferring realization of income until cash has been received may avoid hardships taxpayers would suffer if immediate realization were required. Suppose, for example, a taxpayer receives a promise of future payment as compensation for services. The fair market value of the promise would be includible in taxpayer's income in the year of the agreement. If the promisor is unable to satisfy the promise, the taxpayer would, upon the obligor's default, realize a loss in the year the obligation became worthless in the amount of the remaining basis of the obligation. The taxpayer would then be allowed to deduct his original basis or the value of the obligation at the time of receipt over payments received on the obligation, which would represent recovery of his basis in the obligation and therefore would not be taxable to him upon receipt. That loss, however, may be of no or only limited use to the taxpayer during that subsequent year because, in subsequent years, the taxpayer may not have sufficient income against which the loss could be offset, causing the excessive amount of tax paid in the original inclusion to exceed the tax benefit resulting from the subsequent deduction. When the promise of future payment constitutes a capital asset, as would be the case if it arises in a casual sale outside the ordinary course of business (I.R.C. § 1222(1), (4)), and the promisor defaults, the loss, assuming the seller was a non-corporate taxpayer, could be used to offset a limited amount of taxpayer's ordinary income for that year. I.R.C. § 1211(b). If the

the tax until payment has actually been received generally only postpones collection of the tax. Thus, at most, the cost to the system through use of the cash method arises from the postponement rather than the forgiveness of tax.[79]

b. Promises which are Treated as Property. Even under the cash method of accounting, there are two circumstances in which promises of future payment are treated as non-cash benefits and result in immediate realization of income. First, the promise of a third party is not treated as a mere promise of future payment, but rather is treated as other property. A continuing relationship with the obligor with regard to the obligation is fundamental to deferral of income for cash method taxpayers who receive promises of future payment. The requirement is predicated on the notion that the payor must have a continued obligation to the taxpayer. At its cessation, the taxpayer will have received all of the consideration he will get from the obligor and, at that time, the transaction should be closed. For example, when a taxpayer receives the promise of a third party from his employer as compensation for services, the fair market value of that third-party obligation would be includible in the taxpayer's income in the year that it is

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obligation were held for more than one year prior to default, use of the loss against other income would be further limited by section 1211(b). Moreover, if the amount of the loss on default exceeds the amount allowable as an offset against current income, no carryback of the loss would be permitted, although the loss could be carried over to future years. I.R.C. § 1212(b).

[79] The distinction in tax treatment between non-cash benefit rights to future payment is hinged on the difference between tax forgiveness and tax deferral. Allowing non-cash benefits to escape taxation at the time of receipt will generally result in complete avoidance of their taxation. Tax will only be collected when the taxpayer sells the property which he receives, if that ever occurs. The taxpayer, may, for example, die without ever selling the property. His estate or the beneficiary of his estate would be entitled to a stepped-up basis. I.R.C. § 1014. Further, the noncash benefit may be entirely used up by the taxpayer during his life if the taxpayer received property or services which he consumed for personal enjoyment. Of course, sufficient postponement of a liability may equal a partial forgiveness because of the time value of money. It should not be forgotten, however, that use of the cash method may often result in the postponement of deductions. Its use, therefore, may accelerate payment of tax as well as defer it.

When the magnitude of deferral benefits derived under the cash method becomes sufficiently great, the Service may be empowered to lessen it. In cases in which the use of the cash method materially distorts the taxpayer's income, the Commissioner can require the taxpayer to change his method of accounting. I.R.C. § 446(b). This power has been exercised, for example, in connection with deductions for pre-paid interest and pre-paid farm expenses. *See* Rev. Rul. 68-643, 1968-2 C.B. 76 (relating to pre-paid interest), *modified*, Rev. Rul. 69-582, 1969-2 C.B. 29. The approach in that ruling was sustained by the Tax Court in Sandor v. Commissioner, 62 T.C. 469, 476-77 (1974), *aff'd*, 536 F.2d 874 (9th Cir. 1976); Resnick v. Commissioner, 66 T.C. 74, 81 (1976), *aff'd*, 555 F.2d 634 (7th Cir. 1977). *See also* Benderson Dev. Co., Inc. v. Commissioner, 38 TCM 540, 540, P-H T.C. Memo ¶ 79,119 at 79,119 (1979). The substantive position regarding the tax treatment of pre-paid interest was later codified as section 461(g) by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

received, even though payments on that obligation will not be received until later years.[80] That sort of third-party obligation is more like other property than simply the promise of the employer, because the employer's connection with the transaction has terminated.

Second, a promise of future payment may be so similar to cash as to render any practical distinction meaningless. For example, if a taxpayer receives a negotiable promissory note from his solvent employer, he could convert that note to cash at will. Thus, what he has received is virtually equivalent to cash and, accordingly, it would seem that the obligation should be treated no differently than cash.

The tax law has responded to this situation by creating the doctrine of cash equivalence. Certain kinds of promises of future payment may be viewed as equivalent to cash in the amount of their fair market value. Thus, a cash basis taxpayer who receives a promise of future payment as an item of income realizes income only if the promise is equivalent to cash. If the promise is not equivalent to cash, then the cash basis taxpayer realizes income only when he receives cash or other consideration in satisfaction of the promise.

c. Defining Cash Equivalence. Although the rule of determining when a promise is equivalent to cash has been articulated in several different forms, the focus of the test generally has been whether the taxpayer could readily convert the promissory obligation into cash in established markets.

In *Western Oaks Building Corp.*,[81] for example, the Tax Court characterized the test as follows:

> In determining whether the right to receive income in the future is equivalent to cash, the test is whether the debtor's promise to pay is embodied in notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce. . . . The obligation must, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce. (citations omitted).[82]

Under a cash equivalence test, such as that articulated in *Western Oaks*, based upon ready marketability, a non-transferable promise of future payment could not be equivalent to cash because it could not be converted into cash.[83] Further, even a transferable promise of future payment may not be

[80] Sproull v. Commissioner, 16 T.C. 244, 248 (1951) (payments made as compensation for past services in trust for the benefit of the taxpayer to be paid out in later years held currently taxable), *aff'd*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174. See note 91 *infra* (relating to compensation for services).

[81] 49 T.C. 365.

[82] *Id.* at 377.

[83] *But see* Watson v. Commissioner, 613 F.2d 594, 599 (5th Cir. 1980) ("non-transferable" and "nonassignable" letter of credit held to be equivalent to cash since taxpayer had right, under applicable state law, to assign the proceeds of letter of credit). *See also* Griffith v. Commissioner, 73 T.C. 933, 942 (1980). Note also that in many cases restrictions on alienation are null and void and without legally binding effect. *See* U.C.C. § 9-318(4) (relating to an obligation arising from the sale of tangible property).

equivalent to cash if there is no established market for the obligation, because it could not readily pass from hand to hand in commerce.

Determining the circumstances under which a promise of future payment is readily marketable has not been without substantial problems.[84] Courts have relied on various factors to determine whether the promise of future payment was easily convertible into cash. In *Cowden v. Commissioner*,[85] for example, the Court of Appeals for the Fifth Circuit dealt with the question of whether a promise of future royalty payments under an oil and gas lease was equivalent to cash. The Court listed the following factors in making its determination:

> (1) whether the promise to pay is issued by a solvent obligor;
>
> (2) whether the promise to pay is unconditional, assignable, and not subject to set-offs;
>
> (3) whether the promise to pay is of a kind that is frequently transferred to lenders or investors; and
>
> (4) whether the promise to pay is transferable at a discount not substantially greater than the prevailing premium for the use of money.[86]

In setting forth this test, the Court explicitly rejected complete reliance on the form of the obligation to determine whether it was equivalent to cash. It reasoned that even a negotiable promissory note, because of the lack of

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[84] The cash equivalence has been the subject of the misconception, which has gained acceptance by some courts, that cash equivalence may depend upon the subjective intent of the obligor. Several cases, principally in the area of income from services, have suggested that the question whether the receipt of a note gives rise to currently reportable income may depend upon whether the note represented payment of the debt, giving rise to immediate income realization, or whether the note was given as mere evidence of the debt, thereby resulting in deferral of income realization until cash payment on the note was received. *See, e.g.*, Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938). Nevertheless, as a practical matter, objective facts have often been viewed as determinative. For example, negotiable notes are generally held to represent payment of the debt, whereas courts have regarded non-negotiable notes as mere evidence of a debt on some occasions, and as payments on others.

The test based on subjective intent, however, is not only difficult to administer, but makes little sense. The proper test should look to the character of the receipt because the touchstone is whether the taxpayer is in an economic position essentially equivalent to having received cash. The subjective intent of the promisor would appear to be irrelevant to this inquiry.

When a cash basis taxpayer receives a negotiable note that is equivalent to cash, he has received something more than a mere promise in connection with the transaction, regardless of the obligor's reason for issuing a negotiable note. Receipt of the negotiable note, therefore, should require immediate realization of income, because it gives the recipient a benefit equivalent to that which he would have had if he received cash, even if the obligor only intended it to evidence the debt.

[85] 289 F.2d 20 (5th Cir. 1961).

[86] *Id.* at 24. Several courts have expressed the view that the determination that an obligation is equivalent to cash may turn on the riskiness of the buyer's obligation. Those cases view a promissory obligation which is salable only with a substantial discount from the face amount as not being readily marketable because a process of negotiation is required to determine price. See note 79 *supra* (discussing the Tax Court's opinion in *Warren Jones*).

creditworthiness of the obligor, may not in fact be readily convertible into cash by the holder.[87]

The *Cowden* factors[88] are important as objective indicia of the ease with which a holder of an obligation can convert it into cash. The relevance of any one of the factors can be questioned but ultimately objective factors are needed to make determinations.

As suggested by some commentators, cases dealing with cash equivalence may be organized into categories based upon the form of the obligation. Notwithstanding the Fifth Circuit's position in the *Cowden* case,[89] Courts have generally held that negotiable notes are equivalent to cash because they have a ready market and are readily convertible into cash.[90] This position is generally consistent with *Cowden* because the term negotiability implicitly means that the obligation is unconditional, assignable, can be transferred without being subject to set-off in the hands of the transferee (the second *Cowden* factor), and is the type of obligation frequently transferred to investors or lenders (the third *Cowden* factor). At the other end of the spectrum, courts have generally held that mere contract rights and non-negotiable notes are not equivalent to cash because they have no ready market.[91] Contract rights under real estate contracts, however, have often

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[87] *Id.* at 24.

[88] Some courts have cited additional factors as relevant in determining whether an obligation is readily marketable, including (1) whether the obligation is adequately secured, Marcello v. Commissioner, 43 T.C. 168, 181 (1964), *rev'd* on other grounds, 380 F.2d 499 (5th Cir. 1967); Wolfson v. Commissioner, 1 B.T.A. 538, 541 (1925); (2) whether the obligor is personally liable on the obligation; and (3) the time to maturity of the obligation, Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468-69 (1933); Wolfson v. Reinecke, 72 F.2d 59, 60 (7th Cir. 1934).

[89] *See* Ginsburg, *supra* note 15, at 562-66.

[90] Doric Apartment Co. v. Commissioner, 94 F.2d 895, 897 (6th Cir. 1938); Marcello v. Commissioner, 43 T.C. at 180.

[91] *See, e.g.*, Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. at 377; Cowden v. Commissioner, 289 F.2d at 24; Estate of Ennis v. Commissioner, 23 T.C. 799, 802 (1955); Ennis v. Commissioner, 17 T.C. 465, 470 (1951) (all dealing with contract rights); Humphrey v. Commissioner, 32 B.T.A. 280, 282 (1935) (concerning non-negotiable note). In Revenue Ruling 60-31, 1960-1 C.B. 174, the Service conceded that a mere promise to pay, not represented by notes or secured in any way, was not regarded as a receipt of income by a cash method taxpayer. Thus, the Service does not attempt to include in income the present value of an unfunded deferred compensation contract even when the employee's rights under the contract are not subject to risk of forfeiture and the employer's ability to pay is beyond question. The ruling does indicate, however, that if the promise is not a mere unsecured promise, the cash equivalence doctrine may apply, causing immediate realization of income by the employee. In that connection, the Service takes the position that a funded non-forfeitable right to future payment results in immediate income to the employee.

At first blush, it seems that the Service's view of the law regarding the cash equivalence doctrine looks to the form of the employer's obligation and ignores the general development of the case law. The ruling, however, is grounded on the argument that an employer who establishes a funded deferred compensation account for an employee, which is not subject to forfeiture by the employee, has replaced his mere promise with a third-party obligation to the employee, the promise of the escrow agent. In this regard, the employee has, according to the Service's analysis, received an economic benefit not dependent upon the employer's promise, since the employer's part of the transaction has terminated upon his funding of the employees' trust. On the other hand, the creation of an unfunded obligation by the employer does not been held to be equivalent to cash because they are frequently readily tradable in established markets.[92]

The concept of cash equivalence is distinct from the concept of ascertainable fair market value. Nevertheless, some courts seem to have confused the two and thereby appear to have strayed from the basic principles outlined above. Much of the confusion surrounding the concept of cash equivalence and therefore the cash method theory emanates from an articulated view that a promissory obligation that has a fair market value is equivalent to cash.[93] In most of these cases, however, the courts have simply misused the term fair market value to be synonymous with readily marketable,[94] or have used the concept of fair market value as a factor in making a determination of marketability.[95] Read in that light, the case law is not nearly so inconsistent as may first appear.

2. *Interaction of Section 1001 with Taxpayer's Method of Accounting.*

Courts have generally accepted the cash method theory and have held that a cash method seller of property does not include the buyer's promise of future payment in the amount realized on the sale unless the promise is equivalent to cash.[96]

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terminate the relationship between the employer and the employee with regard to the particular payment to be made under that obligation. That situation therefore constitutes an area in which the concept of economic benefit is subject to the recipient's method of accounting. Accordingly, one might speculate that if a market were ever to develop for unfunded employer obligations, secured or unsecured, receipt by the employee of such an obligation would give rise to immediate income. This is exactly the result suggested by Levin & Javaras, *Receipt of Notes and Other Rights to Future Payments by a Cash Basis Taxpayer*, 54 A.B.A.J. 405 (1968).

[92] *See, e.g.*, Heller Trust v. Commissioner, 382 F.2d 675, 681 (9th Cir. 1967), *aff'g* 24 TCM 1663, P-H T.C. Memo ¶ 65,302 (1965) and 25 TCM 634, P-H T.C. Memo ¶ 66,121 (1966).

[93] *See* Bedell v. Commissioner, 30 F.2d 622, 624 (2d Cir. 1929); Humphrey v. Commissioner, 32 B.T.A. at 282.

[94] *See, e.g.*, Bedell v. Commissioner, 30 F.2d 622, in which the Court of Appeals for the Second Circuit made the following statement:

> If a company sells out its plant for a negotiable bond issue payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title, appears to us a strained use of language, when calculating profits under the income tax. . . . [I]t is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and higgling with him on the basis of the particular transaction.

Id. at 624. *See also* Humphrey v. Commissioner, 32 B.T.A. 280 (cash equivalence test discussed in essentially same terms).

[95] For example, the Tax Court in Estate of Wiggins v. Commissioner, 72 T.C. at 713-14, found that the obligation of future payment in question had no ascertainable fair market value. The determination that the right to future payments had no ascertainable fair market value obviated the need to reach the question of ready marketability.

[96] *See* Warren Jones Co. v. Commissioner, 60 T.C. at 667; Estate of Hurlburt v. Commissioner, 25 T.C. 1286, 1288-89 (1956), *nonacq.*, 1956-2 C.B. 10; Estate of Ennis v. Commissioner, 23 T.C. at 802; Ennis v. Commissioner, 17 T.C. at 469; Johnston v. Commissioner, 14 T.C. at 565-66.

Some courts, the Service, and several commentators,[97] however, have taken a contrary view. They have based their opinions on the proposition that a fundamental difference exists between the tax treatment of sales of property and of income from other sources. Unlike other sources of income, gain from sales is governed by a specific section of the Code, section 1001, which provides for the realization of gain equal to the excess of the cash and fair market value of property received over the taxpayer's basis in the property sold. It draws no distinction between the application of the section to a cash method taxpayer and an accrual method taxpayer.[98] Moreover, some commentators have taken the position that as a matter of tax policy no distinction should be drawn because methods of accounting should only have importance in connection with a taxpayer's trade or business. The tax treatment of a sale of property should be the same for similarly situated taxpayers regardless of their method of accounting.[99] Cash method sellers should not be treated more favorably than accrual method sellers and should suffer the same hardship of paying tax before payment has been received. Accordingly, a cash method seller should include the value of the purchaser's obligation of future payment in the amount realized on the sale.

a. Warren Jones Co. v. Commissioner. The Ninth Circuit's opinion in *Warren Jones Co. v. Commissioner*[100] presents a clear judicial rationale in support of the position that the taxpayer's method of accounting is irrelevant to the tax treatment of a sale of property. *Warren Jones* involved a situation in which a cash method taxpayer sold an apartment building for a total contract price of $153,000. The taxpayer received $20,000 down and a contractual right to receive additional monthly amounts over a fifteen-year period, the promissory obligation bearing an interest rate of eight percent.[101]

The Tax Court found that although no note, securities or other instruments passed between the buyer and the taxpayer, the contractual obligation was transferable, real estate contracts of the type involved in the transaction were regularly bought and sold in the locality of the transaction, and

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[97] *E.g.*, Haley, *supra* note 65; Llewellyn, *supra* note 91, at 1340; Levin & Javavas, *supra* note 91, at 406 (recognizing that courts have generally held to the contrary, but advocating that the doctrine of cash equivalence is not relevant based on legislative history of § 1001).

[98] The Service has recently reiterated this position in a private letter ruling. I.R.S. Letter Ruling 8001001, Sept. 4, 1979, unconvincingly distinguished a Revenue Ruling, Rev. Rul. 58-162, 1958-1 C.B. 234, on the grounds that the published ruling was based on the constructive receipt doctrine and that the fair market value of the promise of payment involved in Revenue Ruling 58-162 could not be determined. The Revenue Ruling, however, did not even discuss this latter issue. In addition, the letter ruling failed to mention that in Revenue Ruling 58-162 the Service accepted the cash method theory for open transaction treatment.

[99] *See* S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION CASES AND MATERIALS 868 (1972).

[100] 524 F.2d 788. The Tax Court had followed a long line of cases sustaining the cash method theory. The Service has recently non-acquiesced in the Tax Court decision, agreeing with the Circuit Court's determination. 1980-23 I.R.B. 5.

[101] 60 T.C. at 665.

the investment community had sufficient funds to take up this contract in the event taxpayer decided to sell it.[102] The Tax Court also found that the taxpayer could have sold this real estate contract to a buyer, such as a savings and loan association, for approximately $117,980, and this figure represented approximately an eleven percent discount off the contract balance of $133,000.[103] The yield on the obligation, based upon its fair market value, would then have been nine and one-half percent. A buyer of such a contract obligation, however, would have required the seller to deposit $41,000 in a restricted savings account, leaving him only $76,980 "free and clear."[104] The court was presented with the question of whether the future right to payment under the real estate contract was taxable to the cash method seller in the year of the sale, or whether tax on those amounts would be deferred until received.

The taxpayer reported the sale as an open transaction under the cash method theory, and reported no gain realized on the transaction until the basis of the property sold had been recovered. Alternatively, the taxpayers claimed entitlement to use statutory installment reporting if the open transaction treatment were not allowed.[105] The Commissioner argued, however, that the real estate contract had an ascertainable fair market value and was readily marketable and, therefore, the equivalent of cash. He also argued that the contract was "property (other than money)" under section 1001(b) and constituted an amount realized by the taxpayer in the year of sale to the extent of its fair market value. The Commissioner, however, conceded the permissibility of the taxpayer's use of installment reporting under section 453.[106]

The Tax Court accepted the argument that the real estate contract had an ascertainable fair market value. It noted that only in rare and extraordinary cases would property be found to lack a fair market value,[107] and that an established market existed in the taxpayer's area for this type of salable real estate contract. The Tax Court concluded, nevertheless, that open transaction treatment was permissible because the buyer's contractual obligation was not equivalent to cash. The court based its conclusion on the finding that it had not been established that the contract could have been sold at any price higher than a discount of almost fifty percent exclusive of the $41,000 which petitioner could not have received outright. This deep dis-

[102] *Id.*
[103] *Id.* at 666.
[104] *Id.* at 667.
[105] *Id.* at 665.
[106] *Id.* at 666.
[107] *Id.* at 667. The Tax Court supported its argument by citing Regulation section 1.1001-1(a) and several judicial decisions. *See generally* McCormac v. United States, 424 F.2d 607 (Ct. Cl. 1970); Darby Investment Corp. v. Commissioner, 315 F.2d 551 (6th Cir. 1963); Marsack's Estate v. Commissioner, 288 F.2d 533 (7th Cir. 1961).

count off the market value reflected the magnitude of the seller's risk and rendered the contractual obligation not equivalent to cash.[108] The Tax Court's conclusion that the large discount from the contract's face amount rendered the obligation not equivalent to cash further fueled controversy over that issue.

The court's implicit view that the cash equivalence doctrine was relevant to the issue of whether open transaction treatment was permissible led the Ninth Circuit to reverse the Tax Court and render its potentially far-reaching opinion. The Court of Appeals stated that "if the fair market value of property received in an exchange can be ascertained, that fair market value must be reported as an amount realized."[109] In so doing, it rejected the cash method theory of open transaction treatment. The court took this position based primarily upon the legislative history of sections 1001 and 453. The shortcomings of the court's analysis can best be seen by reviewing the history of these sections.

The court viewed the evolution of section 1001(b) as indicating that the amount realized on the sale of property includes the fair market value of property received if that fair market value can be ascertained. It noted that before the enactment of the Revenue Act of 1924, a promise of future payment was required to be "readily realizable" before it could constitute an amount realized for purposes of determining gain on the sale of property.[110] The 1924 amendment to the predecessor of section 1001 eliminated

[108] Referring to this point, the Tax Court's opinion, 60 T.C. at 668, n.3, read as follows:

> We note that on these facts it is perhaps improper 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 ease of marketability rests upon the cheap selling price).

[109] 524 F.2d at 792. The Ninth Circuit's opinion on this point had been foreshadowed by a prior decision, Heller Trust v. Commissioner, 382 F.2d 675. The case involved a sale of duplexes by taxpayers for a cash down payment and a contractual obligation of future payments for the balance of the purchase price by the buyer, secured by a mortgage on the property. The taxpayers, who used the cash method of accounting, claimed that the contracts received from the purchasers of the duplexes had no ascertainable fair market value and, accordingly, reported the payments on the contracts as income only in the year in which the payments exceeded their adjusted basis of the property sold.

The Tax Court held that the deferred payment contracts had a fair market value of 50% of their face value and, to that extent, were includible in the taxpayer's income in the year of sale, even though the taxpayer was on a cash method of accounting. The Court of Appeals affirmed the Tax Court and rejected the taxpayer's argument that the contractual obligations of the buyer did not have an ascertainable fair market value because they were non-negotiable. The court grounded its decision entirely on whether the contract had an ascertainable fair market value, thereby implicitly denying the relevance of the seller's method of accounting and the issue of cash equivalence upon which the Tax Court had focused. The court stated that "it was enough for the trial court to find that the contracts did have an ascertainable fair market value when received." 382 F.2d at 681. Thus, the Ninth Circuit viewed the issue as whether the contracts had an ascertainable fair market value rather than, as the Tax Court had opined, whether the contracts were equivalent to cash to the cash method seller.

[110] Prior to the amendment, the predecessor to section 1001(b), from the Revenue Act of 1921, section 202(c), read as follows:

the words "readily realizable" from the phrase "readily realizable fair market value."[111] Based upon a Treasury regulation purportedly interpreting the 1921 statute, the court viewed the pre-1924 amendment requirement to be essentially the same as the current concept of cash equivalence.[112] The court inferred from the amendment that Congress intended the determination of the amount realized upon the sale of property to no longer depend upon whether the property received by the seller was readily marketable and therefore equivalent to cash. Rather, the court concluded that under the law subsequent to the amendment, it was only important that the property received had a fair market value whether or not that value could be readily converted into cash by the seller.

A proper interpretation of the legislative history of section 1001, however, has quite different implications and indicates that the 1924 amendment was intended to deal with the issue of determining the value of consideration received on a sale, the issue involved under the no ascertainable value theory. The amendment was not, contrary to the rationale in *Warren Jones*, designed to reject the cash method theory and render irrelevant any determination of the marketability of the buyer's promise.

This view is supported by the legislative history of the Revenue Act of 1921, which added the phrase "readily realizable market value" to the law. The Act added section 202(c):

> For purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value. . . .

The Report of the House Ways and Means Committee,[113] in discussing this change in the law, viewed section 202(c) as establishing four exceptions to the general treatment set forth in section 202(b) that gain or loss was to be determined by the difference between amount realized and basis. Three

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> For the purposes of this title, on an exchange of property, real, personal, or mixed, for any other property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value. . . .

[111] Subsequent to the 1924 amendment, section 202(c), the predecessor to section 1001(b), read as follows:

> 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. . . .

[112] Treas. Reg. 62, art. 1564 (Rev. Act of 1922) provided:

> [P]roperty has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property.

[113] H.R. REP. NO. 350, 67th Cong., 1st Sess. (1921).

of the exceptions correspond generally to the exceptions specifically provided in the statute.[114] The fourth exception, listed first in the Committee report, applies:

> [w]hen the market value of the property received cannot be satisfactorily determined.

It is clear that this exception was intended to explain the inclusion of the words "readily realizable fair market value" in the statute. Thus, this phrase, added to the statute in 1921 and removed in 1924, had nothing whatever to do with any requirement of marketability, but rather was intended to provide guidance for determining when property could be valued.

Moreover, under the law prior to the 1921 enactment, courts accepted the proposition that a cash method taxpayer reported income on a sale only on the receipt of cash or its equivalent and not on a mere promise of payment.[115] Accordingly, the addition to the law of the phrase "readily realizable market value" in the 1921 Act could not have been intended to exclude from realization for the cash method taxpayer mere promises of payment since these were already excluded under the law prior to the 1921 enactment.

Furthermore, the report of the Ways and Means Committee[116] and the report of the Senate Finance Committee[117] both indicate that the 1924 amendment which removed the phrase from the statute was intended not to change the law, but rather to clarify existing law. In particular, both reports reveal Congressional apprehension that the language requiring that the property received must be "readily realizable" was confusing, extremely difficult to apply, and, therefore, unworkable.[118] Thus, in stark contrast to

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[114] The section of the 1921 Act provided for exceptions to this general rule in cases of like-kind exchanges, section 202(c)(1), reorganizations, section 202(c)(2) and transfers to a controlled corporation, section 202(c)(3). These exceptions are now codified, after substantial refinements, as sections 1031, 368 and 351 respectively.

[115] *See* Atkins v. Commissioner, 9 B.T.A. 140, 149 (1927) (dealing with the law prior to the Revenue Act of 1921).

[116] H.R. REP. No. 179, 68th Cong., 1st Sess. 12-13 (1924).

[117] S. REP. No. 398, 68th Cong., 1st Sess. 13-14 (1924).

[118] The House Ways and Means Committee Report, H.R. Rep. No. 179, 68th Cong., 1st Sess. 12-13 (1924), provides:

> Subdivision (c) does not correspond to any provision of the existing law but embodies in the law what is the correct construction of the existing law; that is, that where income is realized in the form of property, the measure of the income is the fair market value of the property at the date of its receipt.
>
> . . .
>
> The existing law provides, in section 202(c), that no gain or loss is recognized (that is, considered for the purpose of determining taxable income) from an exchange of property unless the property received in exchange has a readily realizable market value. The provision is so indefinite that it can not be applied with accuracy, nor with consistency.
>
> . . .

Similarly, the Senate Finance Committee Report, *supra* note 67, provides:

> Subdivision (c) does not correspond to any provision of the existing law but em-

the inference drawn by the Ninth Circuit, the legislative history of section 1001(b) provides no support for the court's view that the removal of the phrase "readily realizable" from the section was intended to change prior law.[119] It follows that the phrase was added to deal with transactions involving consideration whose value could not be ascertained, a concept significantly different than the concept of marketability, the focus of the cash equivalence doctrine. The phrase was removed in a further attempt to deal with the problem.[120]

One conclusion can be drawn from the foregoing discussion: the legislative history of section 1001(b) does not support the Ninth Circuit's conclusion in *Warren Jones*. On the contrary, it appears that Congress did not

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> bodies in the law what is and has always been the construction of the law adopted by the department and by the courts; that is, that where income is realized in the form of property the measure of the income is the fair market value of the property at the date of its receipt.
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> . . .
>
> Section 203: The existing law provides, in section 202(c), that no gain or loss is recognized from an exchange of property unless the property received in exchange has a readily realizable market value. Great difficulty has been experienced in administering this provision. The question whether, in a given case, the property received in exchange has a readily realizable market value is a most difficult one, and the rulings on this question in given cases have been far from satisfactory. Furthermore, the construction placed upon the term by the department has restricted it to such an extent that the limitation contained therein has been applied in comparatively few cases. The provision can not be applied with accuracy or with consistency.

[119] The language of section 202(c) prior to the 1924 amendment could have been interpreted to permit deferral of realization if either (1) the property received by the seller had an ascertainable fair market value but had no readily realizable fair market value, and thus was not readily marketable. Under this interpretation of pre-1924 law, sellers who received tangible property or intangible property such as corporate stock could avoid immediate realization if that property was not readily marketable. The law permitted the potential abuse by taxpayers who chose in kind consideration over cash consideration. Thus, the 1924 amendment may be viewed as making clear that all property, whether or not it was easily salable, must be included in the amount realized by the seller.

[120] The confusion which resulted from the use of the phrase, to which the Committee Reports to the 1924 Act made reference, can best be seen in a colloquy between Senators Walsh and McCumber, which took place during a discussion of the bill in the Senate:

> Mr. Walsh of Massachusetts. I would like to ask the acting chairman if it would not be better to insert the word "ascertainable" in lieu of the word "realizable," on line 21, page 11?
>
> Mr. McCumber. I can see no reason for making the change suggested. It reads, "has a readily realizable market value." If we are to get the money out of the property and out of the sale, there must be a realizable value, and a realizable value is what it can be sold for, what can be realized.
>
> Mr. Walsh of Massachusetts. I do not know that it is particularly important, but it has been suggested to me that "ascertainable" would be more effective in the administration of the law than "realizable."
>
> Mr. McCumber. "Ascertainable" would mean nothing more than a mere measurement to ascertain the value. It seems to me what we want to get at is what could be actually realized on the sale. It may be worth a certain amount, and yet it may not be salable for that amount.

61 CONG. REC. 6549 (1921).

even focus on the interaction of the computation of gain with a taxpayer's method of accounting, but rather was attempting to deal with the quite different issue of determining the amount realized when the value of the property received on the sale could not be ascertained. In other words, Congress was wrestling with the difficulties of determining fair market value and not with reporting requirements for cash method taxpayers.

The Ninth Circuit's analysis viewed the significance of the 1924 legislative change as affecting the tax treatment of promises of future payment by assuming the conclusion that a promise of future payment received by a cash method taxpayer was property for tax purposes. For a cash method taxpayer, however, a mere promise of future payment which does not rise to the level of cash equivalence does not constitute property for tax purposes. Accordingly, the 1924 language change removing the requirement of "readily realizable fair market value" could not affect the tax treatment of such promises. In short, the Ninth Circuit improperly assumed that all promises of future payment constituted property without recognizing the longstanding exception to the rule which the cash method of accounting has carved out for non-cash equivalence promises.

The second aspect of the Ninth Circuit's analysis of the legislative history in *Warren Jones* involved section 453 prior to its amendment by the Installment Sales Act. The court looked at the Committee reports of the statute which originally enacted the section[121] and concluded that Congress intended section 453 to be the exclusive method for deferring tax on income from sales for deferred payments in a fixed amount, and that for sales not under the installment method, the fair market value of all such obligations of future payment are includible in the amount realized by a seller of property in the year of sale. In reaching these conclusions, the court relied on a statement in the Committee Report to the effect that obligations not qualifying under the section for installment method treatment should be regarded as the equivalent of cash.[122]

The actual implications of the statement in the Committee Report differ markedly from those drawn by the Ninth Circuit. The statement in the Senate Finance Committee Report must be regarded in the context of the entire Report to be properly understood. It appears in a portion of the Report concerned with the initial payment limitations in the statute. The limitation generally provides that a seller of property who receives more

[121] Section 453 was originally enacted as section 212(d) of the Revenue Act of 1926.

[122] The report of the Senate Finance Committee, S. Rep. No. 52, 69th Cong., 1st Sess. 19 (1926), relating to section 212(d), provided that "obligations that are received in addition to the initial payment are to be regarded as the equivalent of cash if such obligations have a fair market value."

than thirty percent of the selling price in the initial year of the sales transaction could not qualify for special installment sale treatment.[123] The portion of the Senate Finance Committee Report immediately following the section referred to by the court deals with the possibility that a deferred payment sale could involve an initial payment in excess of the statutory limit. It indicates that the types of obligations which Congress intended to reach in enacting the installment sale provisions were obligations to the seller secured by the property sold in the transaction.[124] The initial payment limitation was designed to insure that deferred payment obligations which did not satisfy the initial payment limitation would be susceptible to valuation because they would be secured by property having a market value in excess of the outstanding balance of the installment obligation. Thus the Senate Finance Committee apparently had in mind those obligations which were adequately secured by the property that was conveyed in the transaction. Viewed in this light such secured obligations, in the Committee's view, would be the equivalent of cash.

The Report did not consider the unsecured promise of future payment received in a transaction that did not meet the statutory requirements for installment sale treatment.[125] It therefore cannot be read as supporting any general proposition regarding the proper tax treatment of promises of future payment. Rather than evidencing any intent to make section 453 the exclusive method for deferring tax on deferred payment sales, the report can only be interpreted narrowly to present the Committee's view regarding the definition of cash equivalence.

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[123] I.R.C. § 453(b)(2)(B). Under the original enactment of this statute, the initial payment limitation was set at 25%. See note 121 *supra*.

[124] The Committee Report stated:

> Deferred-payment contracts other than installment contracts are not affected by the committee amendment. When the initial payment exceeds 25 percent of the price in the case of an isolated sale of personal property, or in the case of sales of real property, the obligations that are received in addition to the initial payment are to be regarded as the equivalent of cash if such obligations have a fair market value. In consequence that portion of the initial payment and of the fair market value of such obligations which represents profit is to be returned as income as of the taxable year of the sale.
>
> The application of the installment basis as provided in the committee amendment should eliminate necessity for appraisals of the obligations of the purchaser in deferred-payment sales, as required under the Board of Tax Appeals decisions, save in those cases where, because of a large initial payment, i.e., one in excess of 25 per cent of the price, *the property sold and serving as security for the unpaid balance has a value adequate to give the obligations a market value* (emphasis added).

S. Rep. No. 52, 69th Cong., 1st Sess. 19 (1926).

[125] This interpretation is supported by Ginsburg, *supra* note 15, at 489 n. 39, in his discussion of the genesis of the initial payment limitation and his reference to the "presumed security for the buyer's obligation" contained in the explanation to the installment sale provision in the Senate report.

Furthermore, the fact that the Committee Report spoke in terms of cash equivalence, a concept only relevant to cash method taxpayers, indicates the Committee's recognition that an obligation must be equivalent to cash before a cash method taxpayer need include it as an amount realized for purposes of realizing gain. Finally, whatever inferences that may be drawn from these Committee Reports regarding the tax treatment of sales of property for promises of future payment can be no more than suggestive of Congressional intent regarding the amendment of a separate, albeit related, statute some two years earlier.[126]

Thus, the Court of Appeals for the Ninth Circuit has professed to extract clarity out of the ambiguity of the legislative history of sections 1001 and 453. It is apparent that no such clarity exists. It is also apparent that any inferences that can be drawn from the histories of the acts are contrary to those drawn by the court.

No court has adopted the Ninth Circuit's views on this question since *Warren Jones* was decided. In two cases which arose subsequent to that decision, the Tax Court explicitly refused to deal with the issue of cash equivalence, preferring to reach its decisions on other grounds.[127] Not surprisingly, however, the Service has adopted the Ninth Circuit's views.[128]

b. Inconsistency with Internal Revenue Service Position. The argument that section 1001 allows for no difference in treatment between an accrual method and a cash method taxpayer has itself been undercut by the Service. The Service has accepted and indeed embraced the requirement that an accrual method taxpayer upon the sale of property must take into account the face amount of the note received, notwithstanding the fact that the fair market value of the note may be substantially less than its face. In Revenue Ruling 79-292,[129] the Service acknowledged this rule and the preeminence of a taxpayer's method of accounting over the uniform application of section 1001.[130] Furthermore, the Treasury has reiterated this position in its temporary regulations.[131]

c. Private Annuity Cases. A second line of cases appears to deny the relevance of the taxpayer's method of accounting to the tax treatment of gain from the sale of property. Those cases deny open transaction treatment to cash basis taxpayers who receive secured private annuities in exchange

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126 This argument is further buttressed by the failure of the Committee Report to mention any difference in treatment of deferred payment sales among taxpayers using different methods of accounting.

127 *See* Estate of Wiggins v. Commissioner, 72 T.C. at 713-14; McShain v. United States, 71 T.C. at 1010.

128 I.R.S. Letter Ruling 8001001, *supra* note 98.

129 Rev. Rul. 79-292, 1979-2 C.B. 287.

130 As may be recalled, section 1001(b) provides that the amount realized from the sale or exchange of property equals the cash plus the fair market value of the property received.

131 Temp. Reg. § 15A.453-1(d)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

for appreciated property. The apparent inconsistency of those cases with the cash method theory requires close examination.

Estate of Bell v. Commissioner[132] involved the taxability of the exchange of stock for a private annuity. Taxpayers Lloyd and Grace Bell transferred all of their stock in two closely held corporations to their children in exchange for the transferees' promise to pay them a lifetime annuity of $1,000 per month. The stock transferred was placed in escrow to secure the promise of the transferees.[133]

Applying section 72, the Tax Court determined the taxability of the periodic payments received by the taxpayers during 1968 and 1969, the years at issue in the case. Under that section, the non-taxable portion of each payment is equal to the amount of the entire payment multiplied by the exclusion ratio, the ratio which the investment in the contract bears to the expected return under the contract.[134]

The issue relevant to the tax treatment of deferred payment sales involved the taxability of the gain realized by the taxpayer upon the exchange of appreciated stock for the private annuity. The taxpayers contended that the transaction should be treated as an open transaction because the annuity had no ascertainable fair market value.[135] The Tax Court, however, rejected that argument because the value of an adequately secured private annuity can be determined based upon actuarial tables and certainty of payment.[136]

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[132] 60 T.C. 469 (1973). *Accord,* 212 Corp. v. Commissioner, 70 T.C. 788 (1978) (Tax Court expressly follows *Bell* in treating gain from transfer of real property for annuity as taxable in year of exchange).

[133] As further security, the agreement provided for a cognovit judgment against transferees in the event of a default. Estate of Bell v. Commissioner, 60 T.C. at 471.

[134] In *Bell,* the Tax Court considered the Commissioner's contention that consistent with Revenue Ruling 69-24, 1969-1 C.B. 43, the investment in the contract, as defined by section 72(c), represented the taxpayer's adjusted basis for the stock transferred in consideration of the transferee's promise of an annuity. The taxpayers, relying on Revenue Ruling 239, 1953-2 C.B. 53, argued that their investment in the contract was the fair market value of the stock transferred. The court, declining to rely on either Ruling because both involved unsecured private annuities rather than secured private annuities, reasoned that the investment in the contract was the amount paid for the annuity contract, simply the fair market value of the property which had been transferred. The court found that fair market value is the comparable cost of a commercial annuity, thereby rejecting the taxpayers' contention that the value of the annuity was some higher amount equal to the fair market value of the stock transferred.

[135] Petitioners, in this connection, relied upon Lloyd v. Commissioner, 33 B.T.A. 903 (1936). In *Lloyd,* a father transferred appreciated stock to his son in exchange for the latter's unsecured promise to make certain annuity payments to his father for life. The court held that the son's promise "[w]as too contingent to value" for purposes of section 1001's predecessor due to "[t]he uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives." *Id.* at 905.

[136] The Tax Court distinguished *Bell* from *Lloyd* on the basis that the latter involved an unsecured annuity agreement under which it was substantially uncertain whether the annuity payments would ever be made. In *Bell,* on the other hand, the court reasoned that the annuity was amply secured by the transfer of stock and by an agreement providing for a cognovit judgment against the transferees in the event of a default.

Interestingly, however, the majority opinion contained no mention of the fact that the private annuity agreement may not have been equivalent to cash and thus, the taxpayers who were on the cash basis of accounting did not receive "property (other than money)"[137] at the time of the annuity agreement. This omission might lead to the conclusion that the court rejected the applicability of the cash method theory to a sale of property.

Judge Simpson, in fact, dissented from Judge Quealy's majority opinion on the basis of this latter point. He argued that the taxpayers could not realize income on the transaction unless their right to receive future income could be deemed "readily transferable in commerce," the concept referred to as cash equivalence. Judge Simpson concluded that a private annuity is not ordinarily a right which is readily transferable in commerce, reasoning that the span of each person's life is too speculative to determine with any certainty the number of annuity payments to be made prior to an annuitant's death.[138]

Simpson, however, rejected open transaction treatment, which would have obtained had the cash equivalence theory been applied to the transaction, on the ground that cost recovery, which would permit all of the early payments to constitute return of basis and all additional payments to constitute capital gain,[139] would be "[m]anifestly inconsistent with the objective of section 72." Instead, he proposed that the transaction should be treated under section 72, modified so that gain from the disposition of the appreciated property would be realized ratably over the term of the annuity.[140]

It seems clear that the majority's rejection of the cash method theory in *Bell* is inconsistent with the cash equivalence cases,[141] unless the annuity character of the transaction triggers section 72, which alters its tax consequences. By reaching its decision without rejecting the cash method theory, the court implicitly viewed section 72 as the exclusive section dealing with

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[137] I.R.C. § 1001(b).

[138] Estate of Bell v. Commissioner, 60 T.C. at 477. In determining whether a right is "readily transferable in commerce," Judge Simpson reviewed prior Tax Court decisions and listed the following factors: (1) whether the right had a readily realizable market value; (2) whether it was freely and easily negotiable; and (3) whether it was the type that commonly changes hands in commerce.

[139] Although not specifically mentioned by the dissenting opinion, imputed interest would presumably still constitute ordinary income under section 483.

[140] Simpson's approach represents an attempt to reconcile section 72 with the treatment of a cash basis taxpayer's sale of property for deferred payments. Specifically, the dissenting opinion suggested that each payment should have an ordinary income component, a capital gain component, and a return of basis component. Based upon the life expectancy of the annuitant, the amount of the capital gain component and the return of the basis component would be determined by adding up the payments that would eventually be made were the annuitant to live his life expectancy. The sum of these components would equal the fair market value of the property sold. Simpson would then have treated the capital gain resulting as nontaxable once the amount received by the annuitant, measured only by these two components, exceeded the fair market value of the contract. Estate of Bell v. Commissioner, 60 T.C. at 479.

[141] This inconsistency was noted by Judge Tannenwald, who concurred with Judge Simpson's dissent in *Bell*, in his dissenting opinion in *Warren Jones v. Commissioner*, 60 T.C. at 670.

annuity transactions. Under this view, once the section is triggered, the entire transaction is governed by it, and other rules which may relate to parts of the transaction are preempted.

This approach, in essence, treats the annuitant as if he first received cash for the property in the amount of the fair market value of the property, and then used that cash to purchase the annuity. One may argue whether section 72 prescribes this treatment; it seems doubtful that it does. But, the result in *Bell* is so heavily invested with the special rules of section 72 that its application to other sales for deferred payments is highly suspect.

C. *Cash Method Theory after the Installment Sales Act.*

1. *The Installment Sales Act.*

Although the cash method theory has been generally accepted by courts, there is some doubt over its survival after the Installment Sales Act. This doubt emanates from the legislative history of the act rather than the statutory language. The language of section 453(d) is abundantly clear that a seller may elect to have the installment method not apply to his transaction. The subsection provides that:

> Subsection (a) [the installment method] shall not apply to any disposition if the taxpayer elects to have subsection (a) not apply to such disposition.

If the installment method does not apply to the transaction, the realization and accounting sections of the Code should be applied without regard to section 453. Under the language of the statute, therefore, a cash method seller who receives an obligation of future payment which is not equivalent to cash should be permitted to report the sale as an open transaction if he elects out of the installment method.

The Senate Finance Committee Report, which adopted the House Ways and Means Committee Report,[142] however, appears to question that result. The Committee Reports state:

> In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as "open" and permitting the use of the cost-recovery method sanctioned by *Burnet v. Logan*. . . . Accordingly, it is the Committee's intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller's obligation is evidenced by a note, contractual promise, or otherwise), and that its use be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained (citation omitted).[143]

Thus, the Committee Reports imply that a cash method seller who receives the purchaser's contractual promise of future payment of a fixed amount

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[142] Hereinafter, the reports will be referred to collectively as the "Committee Reports."

[143] H.R. Rep. No. 96-1042, 96th Cong., 2d Sess. 21 (1980); S. Rep. No. 96-1000, 96th Cong., 2d Sess. 24 (1980).

may not report the sale as an open transaction even if the purchaser's promise is not equivalent to cash. The Committee Reports construe the statutory language as legislating the proposition that open transaction treatment is no longer available under the cash method theory, at least in cases involving fixed sum obligations. The Committee Reports go even further by interpreting the statute as denying such treatment to contingent price obligations if the value of the obligations can be ascertained. In short, the Reports and the statutory language conflict on the question of whether the cash method theory survives the Installment Sales Act.

Analysis of that question involves two issues. First, can the Committee Reports be used as conclusive authority for the interpretation of the actual statutory language of section 453 and can they preempt other related sections and prior case law? Second, even if the Committee Reports could be given this broad deference, should such deference be shown them in light of their lack of understanding of prior law and related principles?

The argument for looking outside the literal words of section 453 for purposes of interpretation has been well developed in other contexts. The interpretation of the statute should look past a mere analysis of the words of the statute. It should focus on establishing the purpose or goal of the statute. In seeking to determine legislative purpose, one may look to extrinsic aids such as legislative history, the most useful of which are the committee reports. Moreover, committee reports written by the House Ways and Means and the Senate Finance Committees in connection with tax legislation perhaps should be given greater weight than the reports of most other committees simply because the tax laws are complex and technical and so great deference should be given to the expertise of the House Ways and Means and Senate Finance Committees.

The Committee Reports to the Installment Sales Act indicate that the legislation was designed to expand the types of transactions covered by the special installment sales rules, permitting deferred reporting and ratable basis recovery for all deferred payment transactions. In light of the expanded scope of the installment method, Congress contemplated reducing and, in some cases, eliminating the availability of deferred reporting previously allowed. Accordingly, section 453 was intended to preempt other tax provisions and provide the exclusive method, save for very limited circumstances, of deferring the reporting of gain on a deferred payment sales transaction.

The difficulty with this argument is that the language of amended section 453 does not expressly provide, imply, or even hint that a cash method seller who elects out of the installment method is covered by any rules other than those which were in effect prior to the enactment of the Installment Sales Act. Furthermore, the language of section 453 does not provide for the preemption by the installment method of the seller's regular method of accounting for purposes of reporting gain from sales. It does not provide for the installment method as the exclusive permissible method for deferring reporting of gain on sales.

Nor does the language of section 453 abrogate the use of the cash method for reporting gains from sales by requiring all sales of property not reported on the installment method to be reported on the accrual method. There is not even a hint in the statute or Committee Reports that an electing seller who reports the sale as a closed transaction must include the face amount of the purchaser's promise to pay in amount realized rather than the fair market value.[144] That would be the case if the seller were required to report the sale as an accrual method taxpayer.

Not even the regulations to be issued pursuant to section 453(i)(1), directing the Secretary to issue regulations to carry out the provisions of the section, can provide support for the Committee Reports' position. Since the language of the statute permits a seller to elect out of the installment method, neither the new rules contained in the section nor regulations issued thereunder should apply to a seller electing out of the installment method. In short, the position taken in the Committee Reports does not square with the treatment of similar and related transactions not dealt with in the Committee Reports, which turn on the taxpayer's method of accounting. The Committee Reports fail to show an understanding of the relation between a taxpayer's method of accounting and other sections of the Code like section 1001.

The statute can be read sensibly to permit the coexistence of open transaction treatment under the cash method theory and the installment method, leaving the choice to the seller in situations involving permissible open transaction treatment. Only the Committee Reports raise doubts as to this interpretation, and there are significant problems with creating statutory language by relying on committee reports. Congress, after all, enacts statutes, not committee reports. Using statements in the reports to create new statutory commands would be tantamount to legislation by committee report. As Justice Frankfurter wrote: "Spurious use of legislative history must not swallow the legislation so as to give point to the quip that only when the legislative history is doubtful do you go to the statute."[145] This view was recently applied by the Tax Court in holding invalid a section 83 Treasury Regulation which was based on the Senate Committee Report.[146] The court said that the committee report was not the statute and could not serve as support for a regulation suffering the same infirmity. "Legislative history is

[144] In fact, Temporary Regulation § 15A.453-1(d)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981) takes exactly the opposite position.

[145] Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 543 (1947).

[146] Tilford v. Commissioner, 75 T.C. 9 (1980).

strictly a tool of statutory interpretation . . .; it cannot be infused with an authority of its own" (citation omitted).[147]

There are sound, practical reasons for reluctance to resort to legislative history when the statute appears clear on its face. First, legislative history is not readily accessible to everyone. Second, lawyers and other tax advisors should be able to rely on the statutory language if it is clear on its face. The costs involved in requiring every tax advisor to trace through committee reports for every statutory provision in order to reach a determination of what Congress really meant in the statute would be unacceptable to the tax system. Third, the use of legislative history is subject to misuse through selective references to that history. For example, proponents of the position that the cash method theory is no longer available after the Installment Sales Act will point to the Committee Reports as clearly demonstrating Congress' purpose in the enactment. Opponents of that position will point to the election out provision of section 453(d), noting that it was the result of a compromise between the Department of the Treasury and important segments of the American Bar Association and the American Institute of Certified Public Accountants without whose combined support the Act would not have been passed.[148] Reading committee reports as determinative of the construction of a statute without looking at other parts of the history of the statute therefore clearly could give rise to misleading conclusions.

Another problem in relying on the Committee Reports as authority that the installment method abrogates the cash method theory involves the question whether the Committee Reports in fact reflect such a Congressional purpose. There are two significant interpretive problems with the portion of the Committee Reports purporting to eliminate the cash method theory. One cannot tell from the Reports as a whole whether the Committees intended to change current law regarding the availability of open transaction treatment under the cash method theory. In their explanation of present law, the Committees were unable to distinguish between the two separate theories under which open transaction could be justified: the cash method theory and the no ascertainable value theory. In discussing the permissibility of open transaction treatment under existing law, the Reports note:

> In the case of a cash method taxpayer where the future payments have no readily ascertainable fair market value, the taxpayer may treat the transac-

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[147] *Id.* at 4333. *Cf.* (omitted citation) Gilbert v. Commissioner, 241 F.2d 491 (9th Cir. 1957), *rev'g* 25 T.C. 81 (1955).

[148] I understand from conversations with participants in the negotiations over the bill, for example, that the American Institute of Certified Public Accountants and members of the American Bar Association Section of Taxation would not have supported the Installment Sales Bill unless cost recovery was available under it. A number of supporters of the bill believed that an election out by a taxpayer would put him back under pre-Installment Sales Act law.

> tion with respect to those payments as "open" and use the cost-recovery method under *Burnet v. Logan*. . . .[149]

The entire discussion of open transaction reporting in the portion of the report dealing with the explanation of the provision, however, is directed at cases involving sales subject to a contingency.[150] The Committee Reports indicate that the new provision was intended to expand the installment method to cover those sales. In fact, it appears that the Committees were unaware that the cash method theory would support open transaction treatment even though the sales price was not subject to any contingency. Viewed in this light, the Committees' statement regarding the unavailability of cost recovery to sales for a fixed price is most puzzling. The Committees' lack of understanding of the prior law upon which it based its explanation of the statute raises substantial doubt that Congress meant to preempt the use by a seller of his normal method of accounting.

Moreover, the relevant section of the Committee Reports is not directed at an analysis of the tax consequences to a taxpayer who elects out of section 453.[151] Therefore, the sentence which purports to proscribe open transaction treatment when a fixed right to future payment which lacks cash equivalence is received by a seller, should have no application to a seller who elects out under section 453(d).

2. *Treasury Regulations.*

Not surprisingly, the Treasury has taken the position in temporary regulations that a seller who elects out of the installment method may not report his sale as an open transaction under the cash method theory. Rather, the temporary regulations provide:

> Receipt of an installment obligation shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, whether or not such obligation is the equivalent of cash.
>
> . . .
>
> An installment obligation is considered to be property . . . without regard to whether the obligation is embodied in a note, an executory contract, or any other instrument, or is an oral promise enforceable under local law.[152]

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[149] H.R. REP. No. 96-1042, 96th Cong., 2d Sess. 20; S. REP. No. 96-1000, 96th Cong., 2d Sess. 23. In *Tax Section Recommendation No.* 1979-10, the Committee on Tax Accounting Problems of the American Bar Association exhibited the same difficulty when drawing this distinction between the cash method and no ascertainable value theories. 32 TAX LAWYER 1484, 1486 (1979). *See also,* Statement of Herbert J. Lerner, C.P.A.-Chairman, Tax Accounting Subcommittee of the Federal Tax Division, American Institute of Certified Public Accountants, *Hearings on H.R. 3899 before the Subcommittee on Select Revenue Measures, Committee on Ways and Means,* 96th Cong., 1st Sess. 9 (1979).

[150] H.R. REP. No. 96-1042, 96th Cong., 2d Sess. 20; S. REP. No. 96-1000, 96th Cong., 2d Sess. 23.

[151] *Id.*

[152] Temp. Reg. § 15A.453-1(d)(2)(i), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

. . .

> Under no circumstances will an installment sale for a fixed amount obligation be considered an "open" transaction.[153]

Such regulations are no more authoritative than the Committee Reports which spawned them.[154] Moreover, if the temporary regulation is viewed apart from amended section 453, it is no more than a reaffirmation of the Service's litigating position, which is contradicted by the weight of judicial authority.[155] As with the case of previously announced positions on the issue, the temporary regulations are inconsistent in their view of the relationship of section 1001 with the tax accounting sections, continuing to require an accrual method seller to include the face amount of the obligation, rather than its fair market value,[156] in the amount realized even though the obligation is property.

3. *Conclusion.*

Thus, an electing cash method taxpayer should be permitted to treat a deferred payment sale as open under the cash method theory if the buyer's promise to pay is not equivalent to cash. Nevertheless, it should be noted that courts, in dealing with tax issues, often defer to legislative intent as purportedly set forth in committee reports,[157] and to Treasury regulations. Because of that deference, it is possible that a court will hold that the cash method theory is no longer available to a seller, at least if the promise of future payment he receives is for a fixed amount. The court would be wrong, however, because such a result could not withstand rigorous analysis.

IV. APPLICATION OF THE NO ASCERTAINABLE VALUE THEORY TO FIXED SUM FINANCIAL OBLIGATIONS

Much of the confusion regarding open transaction treatment has resulted from the lack of understanding that two separate and distinct theories support open transaction treatment: the no ascertainable value theory and the cash method theory. This confusion has led some courts to extend the boundaries of the no ascertainable value theory to fixed sum financial obligations. Before this issue can be examined in depth, however, the relation of the no ascertainable value theory with the taxpayer's method of accounting must be examined.

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[153] Temp. Reg. § 15A.453-1(d)(2)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

[154] See note 147 *supra.*

[155] See note 96 *supra.*

[156] Temp. Reg. § 15A.453-1(d)(2)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

[157] *See, e.g.*, Snow v. Commissioner, 416 U.S. 500, 503 (1974) (disallowance of § 174(a)(1) declared contrary to broad legislative objective as manifested in legislative history); Commissioner v. Bilder, 369 U.S. 499, 502 (1962) (in disallowing medical expense deduction, Court deferred to express congressional purpose as stated in House and Senate committee reports).

A. *Interaction of the No Ascertainable Value Theory with the Taxpayer's Method of Accounting.*

Sales by cash method taxpayers are permitted open transaction treatment under the no ascertainable value theory when the promise of payment which constitutes the consideration received in the transaction cannot be valued. Should the purchaser's promise of future payment have no ascertainable value, it would not be readily marketable and, therefore, would not be equivalent to cash. Accordingly, the no ascertainable value theory overlaps in large measure with the cash method theory. In fact, the Supreme Court in *Burnet v. Logan* seemed to understand this close relationship when it held the purchaser's contingent payment obligation both not equivalent to cash and without ascertainable fair market value.[158]

The no ascertainable value theory, however, does have independent significance for a cash method taxpayer. First, the theory will permit open transaction treatment if the seller receives a third-party obligation which has no market value.[159] Under the cash method theory alone such an obligation would constitute other property and its receipt would not result in open transaction treatment.[160] Second, courts have often relied on the no ascertainable value theory instead of the cash method theory in order to avoid deciding whether the cash method theory is valid.[161]

The no ascertainable value theory applies somewhat differently to an accrual method taxpayer than to a cash method taxpayer. Sales by accrual method taxpayers, in general, are permitted open transaction treatment when the consideration *to be* received cannot be valued.[162] The theory as applied to an accrual method taxpayer, therefore, will result in open transaction treatment if the actual payments that the seller will receive, rather than the promise of payment itself, cannot be valued. Thus, the theory will apply if the payments are contingent upon future events because the payments to be received cannot be determined. Both cash and accrual taxpayers can therefore be permitted open transaction treatment in their contingent price sales.

The difference in application of the no ascertainable value theory is important, however, if the face amount of the obligation is fixed. As an accrual method seller generally must take into income the face amount of the buyer's obligation, the value of that obligation will be irrelevant. The theory does not apply when an accrual method seller receives a fixed sum

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[158] 283 U.S. at 413.

[159] Corporate liquidation cases are the most important examples. See note 43 *supra*.

[160] See note 69 *supra*.

[161] *See, e.g.*, McShain v. United States, 71 T.C. at 998; Estate of Wiggins v. Commissioner, 72 T.C. at 713 (courts in both cases refused to become embroiled in issue).

[162] J. Freeland, A. Lind & R. Stephens, Fundamentals of Federal Income Taxation, 872 (2d ed. 1977).

promise of payment from a solvent buyer, even if the value of that promise cannot be ascertained.[163]

B. *Application of the No Ascertainable Value Theory to Fixed Sum Financial Obligations.*

1. *Application Prior to the Installment Sales Act.*

As discussed previously, courts have generally permitted open transaction treatment under the no ascertainable value theory when the consideration received by the seller is a right to future payment based upon production or use of a unique property. Taxpayers, however, have been successful in extending the application of open transaction treatment under that theory to situations involving the receipt by the seller of a fixed sum financial obligation as consideration. For example, in *Miller v. United States*,[164] *McShain v. Commissioner* [165] and *Estate of Wiggins v. Commissioner*,[166] fixed

[163] This statement may be subject to a caveat. With respect to the sale of real property, the weight of authority appears to hold that only the fair market value of the buyer's obligation, rather than its face value, is includible in the amount realized. See note 15 *supra*. It follows that the no ascertainable value theory would apply to sales of real property by accrual method taxpayers in the same manner as it applies to sales by cash method taxpayers. The temporary regulations, however, take the contrary view that an accrual method taxpayer include the face amount of the buyer's obligation for all sales, the position stated in the text. Temp. Reg. § 15A.453-1(d)(2)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

[164] 235 F.2d 553, 558 (6th Cir. 1956). The *Miller* case involved the shareholder of a corporation which built and sold homes. The corporation would receive 90% of the purchase price in cash, obtained by the purchaser by loan from an outside lender, secured by a first mortgage on the real estate purchased. In addition, the corporation took back a note for the remaining 10% of the purchase price, secured by a second mortgage on the real estate. When, upon liquidation of the corporation, the taxpayer received the second mortgage notes, he claimed that they had no fair market value. They were, therefore, not part of the amount realized upon liquidation. In support of his position, the taxpayer produced evidence at trial that he had tried to sell the notes but was unsuccessful in finding any market for them.

The Service asserted that the notes received by the taxpayer were includible in his income in the year of liquidation at their fair market value. Furthermore, the Service claimed that the fair market value of the notes was equal to 25% percent of the face amount. The government based its valuation on the subsequent collection history of the notes. The Court of Appeals for the Sixth Circuit, however, held that the notes had no fair market value, since, as second mortgage notes, they were a highly speculative investment. Despite the court's conclusion that the notes had a fair market value of zero, it seems clear that the notes were not worthless. They had a value, albeit one that was speculative or non-ascertainable. Accordingly, the court permitted the transaction to be treated as an open transaction, allowing deferral of realization and cost recovery, even though the taxpayer had received a fixed sum financial obligation as partial consideration for the exchange of his stock.

[165] 71 T.C. at 1007. The taxpayer in *McShain* sold a leasehold interest in exchange for consideration, part of which was a second mortgage note of a fixed sum secured by the leasehold interest. The Tax Court concluded that the second mortgage note had no ascertainable fair market value "because of the speculative nature of the underlying collateral, because of the absence of a market for the note, and because of other factors negatively influencing value. . . ." *Id.* at 1007. Accordingly, the court permitted open transaction treatment.

[166] 72 T.C. 701. Again, the court viewed the speculative nature of the purchaser's obligations as resulting in a situation in which it was "impossible to determine with fair certainty the market value of the contracts for deed as of the date of sale under the traditional definition of fair market value." *Id.* at 713-14. The court distinguished *Warren Jones* by pointing out that

sum financial obligations were held to have "no fair market value" because it was impossible to determine how much of the obligation could be collected.[167]

The extension of open transaction treatment under the no ascertainable value theory in those cases seems unwarranted. Any determination that a purchaser's promise of payment cannot be valued should proceed from uncertainty over the unique facts and circumstances making reasonable estimates impossible and not merely from doubt whether the face amount will not be collected. In *Burnet v. Logan*, the uncertainty of what the seller would eventually receive depended upon how much ore was in the conveyed land and the amount of ore which the buyer of the land would ultimately extract. The first factor, presumably, was not susceptible of determination at the time of the transaction at issue. The second factor never could have been accurately determined since it was dependent upon the decisions which the buyer of the property would make in the future. The Court therefore determined that it was impossible to make any reasonable estimate of the amount which the seller would ultimately realize from the sale. In other words, neither a willing buyer nor seller could possibly have reasonable knowledge of the relevant facts since the outcome depended on future events. Similarly, in *Dorsey v. Commissioner*, the uniqueness of the property, a patent to produce pinspotting machines for bowling alleys, and the uncertainty of the production of such machines or use of the patent by the licensee led the court to conclude that any determination of value of future royalty payments based upon the sale or lease of the machines would be mere conjecture.[168] In both situations, because of the character of the property and future decisions to be made by third parties, the promise of future payment was not susceptible of valuation.

By contrast, the uncertainty in *Miller*, *McShain*, and *Estate of Wiggins* involved the value of a financial obligation which typically is based upon the creditworthiness of the obligor, the value of the property which secures the obligation, and the rate of return. These three factors are commonly dealt with by financial institutions. Although, perhaps, one could never know whether a particular obligor would suffer such financial reverses that he would become unable to satisfy the obligation, this type of extension of credit is sufficiently common to allow creditors to make reasonable judgments, based upon objective facts, of the likelihood of repayment, and therefore, taking into account the interest rate, the value of the obligation. The degree of risk would, of course, affect the value of the obligation, and if

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the consideration received by the seller there had an ascertainable fair market value based on the facts involved in that case. See note 47 *supra*.

[167] Such obligations, on the other hand, have been held to be includible in the income of an accrual method taxpayer in the year of the sale. See text accompanying note 15 *supra*; Jones Lumber Co. v. Commissioner, 404 F.2d at 766-67; George L. Castner Co. v. Commissioner, 30 T.C. at 1072.

[168] 49 T.C. at 629.

the risk were sufficiently great, render the obligation valueless. But, unless one is willing to accept the notion that any obligation which bears the risk of default cannot be valued, one should be very reluctant to take the position that the ability to value an obligation could be based upon the likelihood of default.[169]

Interestingly, both *McShain* and *Estate of Wiggins* declined to apply the cash method theory and, in fact, expressly refused to determine whether the cash method theory as a matter of law would support open transaction treatment. It is apparent, however, that the taxpayers would have prevailed under that theory.

2. *Application after the Installment Sales Act.*

The Committee Reports to the Installment Sales Act express the view that Congress intended to prohibit open transaction treatment to sellers who receive fixed sum financial obligations and to limit its use to contingent price sales.[170] The temporary regulations also seek to proscribe open transaction treatment to fixed sum sales.[171] As the discussion of the election-out provision and its relation to the cash method theory points out, section 453(d) is quite broad and should put an electing taxpayer in the position in which he would have been absent section 453.[172] Neither the Committee Reports' statement nor the Treasury regulations should be determinative of this issue.

There is an additional reason why the Committee Reports' expressed intent should not be given weight under the no ascertainable value theory. That reason arises when a shareholder of a liquidating corporation receives a third party's obligation, previously owned by the corporation, which is for a fixed sum, but has no ascertainable value. Under the weight of decided cases discussed in this part of the article,[173] the shareholder could qualify for open transaction treatment on the liquidation.

The Committee Reports purport to change that result on the grounds that the Installment Sales Act created a uniform scheme under the installment method for reporting deferred payment sales. The Act allows for deferral of gain and ratable basis recovery. As a result, there is no longer a need to permit open transaction treatment when fixed sum obligations are involved.

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[169] Evidence that the obligation could not be sold should not be determinative of absence of fair market value in these cases. Although marketability of an obligation should be relevant to qualification under the cash method theory, the lack of marketability merely means that investors choose not to invest in that type of obligation so that no ready market is available to take up the obligation.

[170] See note 143 *supra.*

[171] Temp. Reg. § 15A.453-1(d)(2)(ii), 46 Fed. Reg. 10,717 (Feb. 4, 1981).

[172] See text accompanying notes 126-37 *supra.*

[173] *See* Miller v. United States, 235 F.2d at 558; McShain v. Commissioner, 71 T.C. at 1010; Estate of Wiggins v. Commissioner, 72 T.C. at 714-15 .

The Committee Reports, however, apparently failed to consider that the shareholder of a liquidating corporation who receives a third-party note is not eligible for installment treatment unless the third party note is received in the sale of corporate assets in connection with a twelve-month liquidation under section 337.[174] Accordingly, prohibiting that shareholder from reporting the exchange of his stock in the corporation for the note as an open transaction under the no ascertainable value theory would appear to be outside the expressed legislative intent in the Committee Reports. Therefore, the Committee Reports' absolute proscription against open transaction treatment for receipt of such obligations must be questioned in light of the inconsistency of that result with the general unavailability of the installment method for shareholders in corporate liquidations.

Nevertheless, courts should be reluctant to extend the reach of the no ascertainable value theory to situations involving any fixed sum financial obligations. That position is based not on the Committee Reports or Treasury Regulations, although it cannot be gainsaid that courts are likely to give some deference to them, but rather on the idea that such obligations are generally susceptible to being valued. In many such situations, however, open transaction treatment should be available under the cash method theory. Recognition of the validity of that theory will take pressure off judicial attempts to fit transactions into the no ascertainable value theory.

V. TAXPAYER ALTERNATIVES

As discussed in Part I of this article, the advantage of electing out of the installment method and treating a transaction as open consists of cost recovery, or recovery of basis by the seller before realization of any gain on the transaction. A seller may elect out of section 453 installment treatment and should be permitted to qualify for the open transaction method under either the cash method theory or the no ascertainable value theory.

It seems likely that taxpayers will be reluctant to attempt to report a transaction as open under either of the two theories. Because installment method reporting will now be available to all types of deferred payment sales, the incentive to attempt open transaction treatment will be much reduced. Moreover, a taxpayer who elects out and tries for the bonanza must satisfy the court that in the case of a cash method seller, the cash method theory continues to live and the consideration he received on the sale was not equivalent to cash or, that in the case of cash and accrual taxpayers, the consideration the seller received could not be valued. If he fails, he will be faced with having the sale treated as a closed transaction and therefore be forced to realize the entire gain in the year of the sale.

[174] I.R.C. § 453(h).

Once an election is made, it cannot simply be revoked at will, but rather requires the consent of the Secretary.[175]

Thus, the Installment Sales Act should succeed in reducing the number of transactions which are reported as open for two reasons. First, the stakes will be high, since an election out will be tantamount to "double or nothing." Second, to elect out, a taxpayer must notify the Commissioner. Such notification could provoke an audit of the transaction and a resulting contest on the issue of cash equivalence or fair market value, whichever the case may be. Under prior law, a sale reported as an open transaction was only reported on the seller's tax return to the extent payment was received, and the seller was not required to file any special election or make any special disclosure.

In deciding whether to elect out of section 453 and to try for open transaction treatment, the taxpayer or his advisor must balance the benefit of cost recovery against the risks of losing deferral and possibly having to report collection gain as ordinary income. When the seller receives a promise of future payment of a fixed amount for a potentially large gain but which bears a high risk of nonpayment, the benefits of cost recovery may be worth the risk of closed transaction treatment. Electing out of installment method treatment may also be advisable if the seller who receives a promise of future payment contingent on future events expects most payments to be received several years before the end of the contractual payment period, but would not be eligible for accelerated basis recovery under the regulations.

This article has examined the tax consequences of deferred payment sales in light of the Installment Sales Act and prior law. It has analyzed the no ascertainable value theory and the cash method theory as two separate theories under which open transaction treatment may be available. Notwithstanding a statement in the Committee Reports to the Installment Sales Act and temporary regulations, it has concluded that the cash method theory should continue to be available in appropriate circumstances, even when the seller receives the buyer's fixed sum financial obligation. In such a case, however, the no ascertainable value theory should not be available to the seller. This analysis was undertaken with a view toward isolating the underpinnings and justifications for permitting open transaction treatment under each theory. It is hoped that it will be useful in guiding courts in resolving tax controversies which arise out of these theories and in guiding practitioners in planning transactions.

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[175] I.R.C. § 453(d)(3); Temp. Reg. § 15A.453-1(d)(4), 46 Fed. Reg. 10,718 (Feb. 4, 1981).