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# Tax Changes Affecting Installment Sales

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## Summary

On December 17, 1999, President Clinton signed the Work Incentives Improvement Act of 1999 (H.R. 1180; P.L. 106-170). This Act included a modification and limitation on the use of the installment method of reporting asset sales for taxpayers who normally use the accrual method of accounting. This change produced a great deal of concern in the small business community.

In response to this controversy, Congress acted to repeal these restrictions on installment method sales. Congressional action on this issue culminated in the passage of the Installment Tax Correction Act of 2000 (P.L. 106-573, H.R. 3594) which was signed into law on December 28, 2000. This Act repealed the restrictions on the installment sale method imposed by the 1999 Act. The repeal was made retroactive to the date of enactment of the 1999 change.

This report will not be updated unless new legislative action is undertaken.

Under pre-December 1999 tax law, some accrual basis taxpayers were allowed to use the installment method of accounting for certain non-dealer asset sales. However, if the cumulative total of outstanding installment sale obligations was greater than $5,000,000 at the end of the year, the taxpayer was required to pay an interest penalty on the deferred tax associated with the installment obligations in excess of the $5,000,000. Installment sales where the asset price was less than $150,000 did not count towards the $5,000,000 limit.

The Work Incentives Improvement Act of 1999 (P.L. 106-170) repealed these provisions by prohibiting the use of the installment method of accounting for accrual basis taxpayers whose sales would otherwise be reported using an accrual method of accounting. The Act also modified the installment sale "pledge" rules so that any arrangement that gave the taxpayer the right to satisfy an outstanding debt obligation with an installment note would be treated as a direct pledge of the installment note and trigger a recognition of gain.

The 1999 Act did not change the availability of the installment method of accounting for the sale of farm property or the sale of timeshare or residential lots. In addition, the

Act did not affect the ability of cash basis taxpayers to continue to use the installment method of accounting.

This change in the tax treatment of installment sales caused a great deal of concern in the small business community. In the past, some small business owners were able to combine the use of seller financing as means of selling their businesses and business assets with the installment method of accounting to calculate their federal income tax on the sale. Many in the small business community argued that it was unfair to tax the full gain from an installment sale at the time of the transaction because in many cases the cash flow generated in the first period of the sale was insufficient to pay the full amount of taxes due. The 1999 Act, however, closed down this tax strategy for any asset sales after the date of enactment, December 17, 1999.

## How Installment Sales Work

Under federal tax law, a sale of an asset is considered an installment sale if the sales contract specifies that at least one payment is made in a tax year later than the tax year in which the sale took place. Under these circumstances, certain accrual basis[1] taxpayers are allowed to use what is basically a cash method of accounting and prorate the gross profit from the sale over the years in which payments are made.

In effect, an installment sale is the exchange of the seller's property for the buyer's promise to pay at a later date. The promise to pay is usually evidenced by a note, mortgage, or other written debt instrument. It is important to recognize that this sale is simply the exchange of one type of asset (the house, small business, or whatever was sold) for another type of asset (the debt instrument).

In general, the normal income tax treatment of exchanges of property is to calculate profit or loss just as if the seller had sold the property for cash, based on the fair market value of the property received in exchange. This rule is to prevent taxpayers' escaping federal income tax through barter arrangements.

However, the installment sales rules are the exception to the general rule. Receipt of the debt instrument alone is not considered as receiving the full amount of income from the sale. Rather, under the installment sales rules, the income is not considered received for income tax purposes until the cash is actually received by the seller in payment of the debt.

The tax advantage of installment sales is the time value of the deferred taxes on the profit. The following simplified two period example of installment sales reporting illustrates this income tax advantage. Consider the case where a property whose basis

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[1] There are two basic accounting methods for federal income tax purposes, a cash basis and an accrual basis. The cash basis is the method used by most individuals; income is reported in the year it is received and deductions are taken in the year in which the related expenditures were actually paid. Accrual basis is the method used by most businesses and individuals engaged in operating businesses. Under this method of accounting, income is recognized when the right to receive it has occurred and expenses are deductible when the liability is incurred.

(original value) was $5,000 is sold for $15,000 by a taxpayer in the highest marginal income tax bracket of 39.6%. We will assume that the market interest rate is 10%.

The difference between selling for $15,000 cash and selling for a promissory note to pay $15,000 in the following year is illustrated in the table below:

**One-Year Value of Deferred Taxes on Hypothetical Installment Sale**

| | Cash Sale | Installment Sale |
|---|---|---|
| Sales Price | $15,000 | $15,000 |
| (Less : Basis of Property) | (5,000) | (5,000) |
| Profit on Sale | $10,000 | $10,000 |
| Profit taxable in year of sale | $10,000 | 0 |
| Federal income taxes @ 39.6% | $3,960 | 0 |
| First year after tax profits | $6,040 | $10,000 |
| Interest on 1st year after tax profits @10 % | $604 | $1,000 |
| Additional profit attributable to installment sales reporting: $396 ($1,000 - $604) | | |

As can be seen from this simplified example, the tax benefits of installment reporting is that interest can be earned on the deferred taxes. In this example, the benefits amounted to $396 , which is exactly a year's interest (at 10%) on the $3,960 in deferred taxes.

Initially it might appear that installment sales also involve a disadvantage because the seller ends up with an IOU instead of cash. However, in economic terms, the installment debt instrument is an asset that the seller can use as leverage to borrow the desired cash. The seller's net worth remains the same, but now he has both the tax advantages of installment accounting and the cash.

The ability of a seller to acquire cash by borrowing against their installment debt obligations has long been recognized by Congress. In an effort to curtail this practice, the federal tax code contains what are referred to as pledge rules. These pledge rules are based on the proposition that anyone who has outstanding both an installment debt owed to them and debt they owe someone else has, in effect, collected part of the installment debt by borrowing against it.

Initially, these pledge rules prohibited just those transactions where there was a direct legal linkage between the installment obligation and a taxpayer's outstanding debt. In other words, the pledge rules prohibited a taxpayer from using his outstanding installment obligations as a direct pledge (collateral) against other borrowing. However, since money is fungible, taxpayers readily found ways around these direct pledge limitations. As a result of these taxpayer maneuvers , the pledge rule restrictions have had to become much more extensive and complicated over time.

## Recent Legislative Changes

Rules governing installment sales have been part of the tax code since the early 1920's and the enactment of the Revenue Act of 1921. In the more recent past, the Installment Sales Revision Act of 1980 broadened the availability of installment sales by allowing the installment method to be used as long as at least one payment was made a year after the date of sale.

Congress revisited installment sales in the Tax Reform Act of 1986, curtailing the tax advantages of these transactions for most taxpayers. In addition, it added the "proportionate disallowance rule" which tried to link the outstanding debt of the seller to outstanding installment obligations owed to the seller. The "proportionate disallowance rule" proved unworkable in practice. Within a year Congress, in the Omnibus Budget Reconciliation Act of 1987, repealed these provisions. In their place, Congress adopted more restrictions on the use of installment sales, repealing the method for dealers and applying interest charges on large non-dealer sales.

More recently, both the Senate's Taxpayer Refund Act of 1999 and the House's Financial Freedom Act of 1999 included provisions that would have repealed the installment method of reporting for most accrual basis taxpayers. These provisions were included in the conference agreement for the Taxpayer Relief and Refund Act of 1999, that passed both chambers but was vetoed by President Clinton.

The Work Incentives Improvement Act of 1999 (H.R. 1180; P.L. 106-170) which was signed by the President on December 17, 1999 included provisions that would prohibit most accrual basis taxpayers from using the installment method of accounting. The Act did not change present law with respect to the availability of the installment method of accounting for sales of assets used or produced in the business of farming or for sales of timeshare or residential lots. In addition, the Act did not change the ability of a cash basis taxpayer to use the installment method of accounting.

The Act also amended the pledge rules so "... that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note."[2] This includes situations where the taxpayer had the ability or right to repay a loan by transferring the installment note to his creditor.

The beginning of the second session of the 106th Congress saw an increase in Congressional concern over the possible negative ramifications of these new restrictions. On January 26, 2000, Senator Conrad Burns introduced legislation (S. 2005) that would repeal the new restrictions on the use of the installment method of reporting. On February 8, 2000, Congressmen Wally Herger and John Tanner also introduced legislation (H.R. 3594) repealing the new restrictions.

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[2] U.S. Congress. Joint Committee on Taxation. *Summary of Conference Agreement on H.R. 1180 Relating to Expiring Tax Provisions and Other Revenue Provisions*. JCX-85-99. November 17, 1999.

The Treasury Department indicated at hearings held by the Ways and Means Committee in February 2000 that they would be issuing new guide lines that would allow certain taxpayers to continue to use the installment method of reporting. IRS Revenue Procedure 2000-22 was subsequently issued on April 28, 2000 and allowed qualified taxpayers with annual average gross receipts of under $1 million to continue to use the installment method of reporting.

Provisions to repeal the restrictions on installment sales were included in several pieces of legislation offered in both the House and Senate during the remainder of the second session of the 106th Congress. Ultimately, Congressional action on this issue culminated in the passage of the Installment Tax Correction Act of 2000 (P.L. 106-573, H.R. 3594) which was signed into law on December 28, 2000. This Act repealed the restrictions on the installment sale method imposed by the 1999 Act. The repeal was made retroactive to the date of enactment of the 1999 change.