

Part III -- Administrative, Procedural, and Miscellaneous

Installment Sales by Accrual Method Taxpayers

Notice 2000-26

PURPOSE

This notice provides guidance in a question and answer format on the application of § 453(a)(2) of the Internal Revenue Code to certain installment sale transactions.

BACKGROUND

An installment sale is defined in § 453(b) to mean generally a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Section 453(a)(1) provides the general rule that income from an installment sale must be taken into account under the installment method. An exception to this rule is set forth in § 453(a)(2), which provides generally that the installment method does not apply to income from an installment sale if the income would be reported under an accrual method of accounting without regard to § 453. Section 453(a)(2) was added by § 536 of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999), and is effective for sales or other dispositions occurring on or after December 17, 1999, the date of enactment. Section 453(a)(2) does not affect the ability of a taxpayer using the cash receipts and disbursements method of accounting to use the installment method.

QUESTIONS AND ANSWERS

The following questions and answers provide guidance on the application of § 453(a)(2) to certain installment sale transactions. Depending on the facts and circumstances of a particular transaction, taxpayers also should consider the applicability of § 453A, which in certain circumstances imposes an interest charge on the tax liability that is deferred through use of the installment method.

Corporations

For each question and answer assume the shareholder uses the cash receipts and disbursements method of accounting and the corporation uses an accrual method of accounting. Also assume the stock of the corporation is not traded on an established securities market. Except as otherwise indicated, the term “corporation” refers to either an S corporation or a C corporation.

Q-1: Can the shareholder report on the installment method the gain arising from a sale of the shareholder’s stock in the corporation in exchange for cash and an installment obligation?

A-1: The shareholder can report the gain from the sale of the stock on the installment method.

Q-2: Can the corporation report on the installment method the gain arising from a sale of the corporation’s assets in exchange for cash and an installment obligation?

A-2: The corporation cannot report the gain from the sale of its assets on the installment method. See § 453(a)(2).

Q-3: What is the effect on the transaction described in Q&A:1 above if the buyer makes an election under § 338(g) (a “§ 338 election”) for the corporation?

A-3: The shareholder is not affected and can report the gain from the sale of the stock on the installment method. The corporation cannot report the gain from the deemed sale of assets on the installment method. See § 453(a)(2).

Q-4: What is the effect on the transaction described in Q&A:1 above if the shareholder is a corporation and the buyer and the corporate shareholder join in making a § 338(h)(10) election for the target corporation, a C corporation, which is either the corporate shareholder's affiliate or a member of its consolidated group?

A-4: The corporate shareholder recognizes no gain or loss on the sale of the target corporation's stock. See § 1.338(h)(10)-1T(d)(5)(iii) of the temporary Income Tax Regulations. The target corporation cannot report the gain from the deemed sale of assets on the installment method. See § 453(a)(2). The corporate shareholder generally recognizes no gain or loss on the deemed transfer of the target corporation's assets (including the installment obligation) to the corporate shareholder because, in most circumstances, the transfer would qualify as a distribution in complete liquidation to which § 332 applies. See § 1.338(h)(10)-1T(d)(5)(i).

Q-5: What is the effect on the transaction described in Q&A:1 above if the buyer and the shareholder join in making a § 338(h)(10) election for the corporation, an S corporation?

A-5: The shareholder recognizes no gain or loss on the sale of the S corporation's stock. See § 1.338(h)(10)-1T(d)(5)(iii). The S corporation cannot report the gain from the deemed sale of assets on the installment method. See § 453(a)(2). The shareholder may realize gain or loss on the deemed transfer of the S corporation's

assets (including the installment obligation) to the shareholder, after taking into account the effect of the deemed sale of the assets. See § 1.338(h)(10)-1T(d)(5)(i). The shareholder can report on the installment method the gain, if any, arising from this deemed transfer. See § 453(h); §§ 1.453-11(a)(2) and 1.338(h)(10)-1T(d)(8).

Q-6: What is the effect on the transaction described in Q&A:2 above if the corporation, a C corporation, distributes the note to a shareholder in a liquidation that meets the requirements of § 453(h)?

A-6: The C corporation must recognize any gain or loss upon the distribution of the note. See § 453B(a). The shareholder can report on the installment method the gain arising from the exchange of the shareholder's stock for the note. See § 1.453-11(a)(2).

Q-7: What is the effect on the transaction described in Q&A:2 above if the corporation, an S corporation, distributes the note to a shareholder in a liquidation that meets the requirements of § 453(h)?

A-7: Except for taxes imposed by subchapter S (e.g., §§ 1374 and 1375), the S corporation does not recognize gain or loss upon the distribution of the note. See § 453B(h). The shareholder can report on the installment method the gain, if any, arising from the exchange of the shareholder's stock for the note. See § 1.453-11(a)(2).

Partnerships

For each question and answer assume the partner uses the cash receipts and disbursements method of accounting and the partnership uses an accrual method of

accounting.

Q-8: Can the partner report on the installment method the gain arising from a sale of an interest in the partnership in exchange for cash and an installment obligation?

A-8: If the sale otherwise qualifies for installment method reporting, the partner is not precluded by § 453(a)(2) from reporting on the installment method the gain arising from the sale of the partnership interest. But see, e.g., § 453(i)(2) and Rev. Rul. 89-108, 1989-2 C.B. 100.

Q-9: Can the partnership report on the installment method the gain arising from a sale of the partnership's assets in exchange for cash and an installment obligation?

A-9: The partnership cannot report the gain from the sale of its assets on the installment method. See § 453(a)(2).

Treatment of Sales Not Eligible for the Installment Method

Q-10: How does a taxpayer take into account an installment obligation received in an installment sale transaction that is not eligible for the installment method for any reason, including § 453(a)(2)?

A-10: The taxpayer generally must recognize the entire amount of the gain from the installment sale in the year of the sale. See § 1001(c). Section 1.1001-1(a) or § 1.1001-1(g), whichever is applicable, will determine the amount of gain that is realized by the taxpayer attributable to an installment obligation issued in exchange for property when the income from the exchange is not eligible to be reported on the installment method. See also §§ 483 and 1271 through 1275, and the underlying regulations, to determine if the installment obligation has either unstated interest or

original issue discount.

Q-11: If an installment obligation providing for one or more contingent payments is issued in the installment sale transaction described in Q&A:10 above, can the taxpayer use the “open transaction” method to report the gain from the transaction? See, e.g., Burnet v. Logan, 283 U.S. 404 (1931).

A-11: In general, the taxpayer cannot use the “open transaction” method to report the gain from the installment sale transaction. Only in those rare and extraordinary cases in which the fair market value of the obligation cannot reasonably be ascertained can a taxpayer use the “open transaction” method to report the gain from the transaction. See § 1.1001-1(a) or § 1.1001-1(g). See also § 1.483-4 or § 1.1275-4, whichever is applicable, for rules concerning the taxpayer’s treatment of the installment obligation.

DRAFTING INFORMATION

The principal author of this notice is Kimberly L. Koch of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding a § 338 election or a § 338(h)(10) election made in connection with an installment sale transaction, contact Victor Penico on (202) 622-7790 (not a toll-free call). For further information regarding the rest of this notice, contact Ms. Koch on (202) 622-4950 (not a toll-free call).