

IRS Proposes to Make Monetized Installment Sales a List Transaction

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I know. I know. Your reaction is probably, “Huh? Do what? I don’t even know what a monetized installment sale is, why should I care.” As my partnership tax professor, Theodore Seto always says, “To understand the rule, you have to know the game that is being played.”

The Problem and the Game:

Here’s what a monetized installment sale is and how it works. Peggy Sue has a low basis, high-value asset. For our example, we assume a tax basis of \$10,000 and a sales price of \$1,010,000 so she has a taxable gain of \$1,000,000. If Peggy Sue sells it straight up, unless she has other offsetting losses elsewhere, will have a lot of gain she must recognize and for which she must pay tax. Let’s say instead of selling it for a lump sum, she sells it in an installment sale payable in ten equal annual installments. Under IRC 453 she would allocate and pay tax on the pro rata portion of the gain each payment represents, so she would pay tax on 100k of gain each year over the ten-year period ($\$1,000,000 \text{ gain} \div 10 \text{ years} = 100\text{k gain per year}$). If Peggy Sue has no other income, spreading the gain over 10 years will prevent a bracket run and result in less of a tax bite. The interest component of each payment will be taxable as ordinary income in the year of Peggy Sue’s receipt of each payment.

Now here comes the game (greatly simplified for brevity): What if Peggy Sue sells to Elvis and takes back a 30-year, interest-only balloon note? Well, the interest is ordinary income, but Peggy Sue won’t recognize any gain until the balloon payment. This defers gain, but Peggy Sue still doesn’t have her money, only the interest payments. But what if Peggy Sue can find a lender who will lend Peggy Sue say 95% of the sale amount (and coincidentally, the payment terms and interest Peggy Sue pays the lender is the same rate as Elvis’s note to her). In other words, the interest received and interest paid cancel out each other. And because a loan ordinarily is not a taxable event, Peggy now gets 95% of the sales price to invest and grow for 30 years. When Elvis pays her the balloon payment in 30 years she pays the lender. Money for nothing and checks for free. Sweet deal, isn’t it?

The Rule (Proposed):

Too sweet, actually. So, the IRS has proposed making this and its variants a listed transaction. Being a “listed transaction” means you have to tell the IRS you are doing it, i.e. flag it on your return, so they can decide if it is legit or not (for a very narrow class of assets—farm land—it actually might work, but even then there are limits and restrictions). Also, if the proposed regulation goes into effect anyone who engaged in a monetized installment in a prior year for which the period of assessment is still open (generally three years from the latter of the due date or the date the return was filed) must send the IRS a disclosure of the transaction. Failure to list (“disclose”) the transaction can result in a penalty equal ****TO**** 75% of the tax savings the transaction produced, together with understatement penalties and interest. And it gets better. If you were required to disclose a listed transaction but didn’t, the period for assessment is extended until one year after the date of disclosure.

Now, until the *proposed* regulation becomes final, this is all somewhat speculative. But if I were a betting man, I would look for a final version of the regulation this fall. Forewarned is forearmed.

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