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The New Need for Up-Front Cash

The Impact of Recapture in Installment Sales—Act of 1984

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The Tax Reform Act of 1984, P.L. 98-369, hereinafter referred to as the "Act," would significantly alter the treatment of any depreciation recapture under Code Secs. 1245 and 1250 when an installment sale is involved. These provisions can have a very detrimental effect on taxpayers who receive little or no cash in the year of sale. The new legislation provides that the total ordinary income is to be recognized entirely in the year of disposition regardless of when the actual payments are received.[1] Under prior law, the ordinary income was recaptured as installments were paid and gain was realized based on the gross profit ratio. The regulations required the ordinary income portion to be recaptured first before the taxpayer could report any portion of the gain as capital gain.[2]

The reason for this change was Congress (in particular the Senate since this provision did not appear in the House bill) felt that there was a potential for a mismatching of income and deductions. They felt that the current law recapture rules for real property act to curb the incentive to "churn" property. However, the installment sale rules permit the deferral of recapture and capital gains tax, and thus there was a potential for churning. Taxpayers could multiply the benefits of accelerated depreciation and investment tax credits by replacing the property as soon as those tax benefits were used, even if it was before the expiration of the useful life of the property.[3]

The purpose of this article is to examine the impact of new Section 453(i) and possible techniques of avoiding its impact.

Background

The concept and rules of the installment sale are clearly laid out in Code Sec. 453. However, the focus of this article is on the nature of an installment sale involving Secs. 1245 and 1250 property and the implications of the recapture provisions as they apply to an installment sale.

The legislative history behind Code Secs. 1245 and 1250 did not make any reference to the manner in which the ordinary income resulting from the application of either provision was to be reported when the installment method was used. However, the regulations did address this situation. Regs. §1.1245-6(d) (1) and §1.1250-1(c) (6) made it clear that the gain portion of each installment payment will give priority to the ordinary income portion until all of the ordinary portion is recognized i.e. 1245 & 1250 gain is to be recognized first.

Perhaps the best way to illustrate prior law is by the following example.

Example (1250 Property). Taxpayer contracts to sell 1250 property for $100,000 to be paid in 10 equal payments of $10,000 each, plus interest. The recapture portion of the gain is $30,000. The adjusted basis of the property is $40,000; therefore, the total gain realized is $60,000. Accordingly, $6,000 of each of the first 5 installments constitute Section 1250 gain and the remaining installments constitute Section 1231 gain.

New Section 453(i)

The new legislation provides that effective for installment sales of real or personal property made after June 6, 1984, any depreciation recaptures under Code Secs. 1245 and 1250 are to be included in income in the year of disposition even though the balance of the gain is to be included in income under the installment method as payments are received.[4] In other words, the ordinary income recaptures are treated as being received in the year of sale, regardless of the fact that the cash may have or may not have been received. Any gain in excess of the recapture income shall be taken into account under the installment method. Also, for purposes of Section 453, the adjusted basis of the property will be increased by the amount of any ordinary income recaptured. This will prevent the taxpayer from being taxed twice on the same gain.

This provision can best be illustrated by referring to the previous example. The previous example involving the sales of 1250 property would result in the taxpayer recognizing $30,000 of ordinary income in the year of disposition and only receiving $10,000 in cash. In addition, the taxpayer would have to recognize capital gain income of $3,000 in the year of sale. This is computed by taking the $10,000 cash received in the year of sale times the gross profit percentage adjusted for the recaptured income (i.e. $10,000 x 30 percent). Assuming the taxpayer is in the 50 percent bracket, this would result in $15,600 of tax liability and only $10,000 to pay the related tax. This result would appear not to be justified on the grounds that it would be unfair to impose a tax payable only in cash when the taxpayer does not have the cash to pay the tax.

The Senate Report did not agree with this argument. They felt that the taxpayer had already greatly benefited from the depreciation deductions, so that actual receipt of payments should not be a factor.[5]

It is interesting to note that this provision not ony accelerates the recognition of ordinary income as compared with prior law, but also accelerates the recognition of a capital gain from a sale of property. In the previous example no capital gain income was recognized in the year of sale under prior law. However, under the new provision capital gain income will be recognized in the year of sale whenever cash is received in that year. Of course the recaptured income is recognized in the year of sale regardless if any cash is received.

Tax Planning Under the New Law

The most obvious technique to avoid the recapture is to forego the ACRS depreciation deduction on real property and elect straight line. Section 1245(a) (5) (c) indicates that when the straight line method is utilized with respect to non-residential property, there is no recapture.

However, the decision to forego ACRS deductions must be carefully considered. Important variables that must be considered are: (1) **Holding Period**—the longer the holding period the more likely ACRS will provide greater benefit. (2) **Time Value of Money** — future costs must be discounted and the higher the discount rate, the more likely the taxpayer should use ACRS, (3) **Resale Price**—if the property is ultimately sold for less than its original cost the gain will be less than the potential recapture amount, and consequently the maximum amount will not be recaptured, even if ACRS is used, and (4) **Tax Rates**—if the taxpayer projects that his marginal tax rate will decrease in the future, ACRS could be more attractive.[6]

If the taxpayer is already subject to recapture he/she should attempt to get enough cash in the year of sale to cover the additional tax liability as a result of the recapture. Referring to the previous example, the taxpayer would require $15,600 cash in year one. These transactions are often made on extremely deferred terms, thus it might be difficult to obtain this additional cash.

One common technique that is used is the wraparound mortgage. In a sale transaction using a wraparound installment obligation, the buyer of the property does not assume the existing debt but instead gives the seller a wraparound installment obligation which reflects the unencumbered value of the purchased property; as part of the sale agreement the seller agrees to make payments on the underlying debt when they come due. This technique resulted in little "up front" cash; therefore, it might not be as attractive to the seller.

Also, if the note issued by the buyer does not have adequate interest the new Original Issue Discount (OID) rules would come into play. Generally, adequate interest will exist if the stated rate is 110 percent or more than the "applicable federal rate." If adequate interest does not exist, the note will be discounted at 120 percent of the "applicable federal rate." Thus, the proceeds from the sale would be reduced; therefore, the gain realized would be less. This could result in converting what would have been capital gain into ordinary income without any reduction in the amount to be recaptured. Accordingly, the buyer would have a depreciable basis equal to the discounted value.

However, assume there is 100 percent recapture and the total gain is ordinary income. If the note issued is subject to the OID rules, it would be discounted; thus, the total gain would be less. Obviously the recaptured income would be less in the year of sale. It is true that there would be original issue discount which would be ordinary income to the seller. However, since the OID is recognized on a geometric progression there would be less ordinary income recognized in the earlier years of the sale. Therefore, although the total ordinary income would be the same, a portion would be spread over the term of the note. Again, the buyer would have depreciable basis equal to the discounted value.

Although it is beyond the scope of this paper, it is important to focus in on the new OID rules when an installment sale is involved.

The more common transaction is where Section 1245 and 1250 property is sold in the same transaction. The taxpayer would be well advised to sell the §1245 properties for book value; therefore, avoiding any potential recapture. It would be advisable to provide in the agreement of sale that the purchase price for each unit of §1245 property be its book value.

Conclusion

The new legislation was enacted to curb a potential abuse in the "churning" of real property by tax shelters. However, the statute is far broader than the harm it was intended to quell.

The Senate bill provided for full recapture in the year of sale on **real** property. This would have restricted the incentive of taxpayers to churn real property. However, the Conference Committee expanded the coverage of this provision by extending it to **all** depreciable property. It is not believed that Congress was concerned with the churning of 1245 property involving installment sales. Therefore, the provision should have been limited to **real** property.

It is estimated that this provision will increase revenues by $39 million in 1984, $91 million in 1985, $177 million in 1986, $192 million in 1987, $209 million in 1988, and $226 million in 1989. Ω

NOTES

[1]New Code Sec. 453(i).
[2]Reg. §§1.245-6(d) (1), 1.250-1(c) (6).
[3]S. Rep. No.98-169 at 466.
[4]See Explanation of Tax Reform Act of 1984, CCH pp. 68-69.
[5]S. Rep. No. 98-169.
[6]See Whitmire and Reynolds, "Selecting the optimum depreciation method for real estate under the new ACR System, *The Journal of Taxation*, Dec. 1981 pp. 360-363. .

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