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TAXING THE SALE OF PROPERTY

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THE FOLLOWING CITATIONS WILL BE USED IN THIS ARTICLE:

Treas. Release No. B-1758 (July 27, 1979) (statement of Harry L. Gutman, Deputy Tax Legislative Counsel, Department of the Treasury, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means) [hereinafter cited as Treas. Release No. B-1758];

J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (1938) [hereinafter cited as J. SEIDMAN];

Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 471 (1975) [hereinafter cited as Ginsburg];

References to the Internal Revenue Code of 1954, as amended (the Code), will be made by section number only. The Internal Revenue Service will be referred to as the "Service."

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I. INTRODUCTION

The federal income tax laws have always included gain from "dealings in property" as an item of gross income,¹ and probably only the payment of wages rivals the sale of property in fundamental importance to taxpayers generally. Nevertheless, the courts and the Internal Revenue Service have yet to develop a consistent and rational approach to taxing the many sales transactions in which the seller takes some evidence of the purchaser's indebtedness in full or partial exchange for the underlying property. Four sections of the Internal Revenue Code are potentially applicable to these transactions: section 1001, dealing with gain from the disposition of property; sections 446 and 451, specifying permissible general accounting methods; and section 453, allowing the installment method of reporting gain from certain types of property transactions. These sections yield inconsistent

1. The first income tax statute adopted after the passage of the sixteenth amendment defined income to include "gains, profits, and income derived from . . . sales, or dealings in property, whether real or personal . . ." Act of Oct. 3, 1913, ch. 16, § IIB, 38 Stat. 114. Current law provides that gross income includes "[g]ains derived from dealings in property." § 61(a)(3).

results, and despite fifty years of dealing with the statutes,² administrative and judicial interpretation of these interrelated provisions remains largely ad hoc. Indeed, few courts have even perceived the tension between the conflicting but potentially applicable statutes, and certainly no court has developed a coherent solution. The decisions instead are arrayed in separate lines of authority, using a wide variety of reasoning that has little or no basis in either policy or statutory language. Cases in each line usually show no awareness that alternative approaches exist. The inevitable result can be expressed in a familiar litany—inconsistent tax treatment of particular taxpayers and great difficulty in tax planning.

This Article argues that the accounting provisions under sections 446 and 451, the installment sale provisions under section 453, and the disposition-of-property provisions under section 1001 are all amenable to one consistent interpretation. The approach is simple, requiring only a distinction between sales of property in the regular course of business and isolated or casual sales. Sales in the regular course of business should be covered by the taxpayer's method of accounting, without reference to section 1001. Section 1001 should apply to isolated sales, regardless of the taxpayer's method of accounting. These rules should be modified only when the installment sale provisions of section 453 are both available and elected.³

This interpretation follows the apparent intent of Congress and gives meaningful but nonoverlapping operative scope to each provision. It ends the inequity that has developed between cash-method and accrual-method taxpayers who engage in isolated-sale transactions by avoiding the logical inconsistency of applying their accounting methods to transactions unrelated to the regular business or employment for which such methods were adopted. Finally, the suggested interpretation provides a unifying theory that eliminates the uncertainty now facing taxpayers about to enter into sale-of-property transactions.

Part II of the Article sets the stage by considering a brief introductory example. Part III reviews the statutory development and argues that the suggested interpretation was probably the one Congress intended when it adopted the predecessors of the current statutory provi-

2. These provisions have remained stable since the mid-1920s. Compare Revenue Act of 1926, ch. 27, §§ 202-203, 44 Stat. 10 (exchange of property), *id.* §§ 200(d), 212(b) (methods of accounting), *id.* § 212(d) (installment method of reporting) with current § 1001 (determination of gain or loss), §§ 7701(a)(25), 446, 451 (general rules for methods of accounting), § 453 (installment method). Amendments to section 453 have been proposed, however. See text accompanying notes 259-82 *infra*.

3. Admittedly this interpretation sounds almost too obvious: If it is workable, one must ask why it was not adopted long ago. Nevertheless, no court has ever taken this approach, and the rest of this Article demonstrates that it indeed works considerably better than the various judicially approved alternatives.

sions. Part IV points out that some of the current judicial approaches are plainly inconsistent with congressional intent and identifies the logic and policy problems that all of them create. Part V analyzes in detail the way in which the suggested interpretation will work in practice, the problems that it raises, and some possible resolutions. Part VI then discusses the impact of this interpretation of the sale-of-property provisions on several related matters: the classic distinction between open and closed transactions; the treatment of amounts received by the seller subsequent to the sale that exceed the seller's basis in the purchaser obligation (the "discount" or "collection gain"); limitations on the installment method of reporting; and tax problems upon a reacquisition of the property sold.

II. AN ILLUSTRATIVE EXAMPLE—THREE TAXPAYERS *A*, *B*, AND *C*

The statutory language is surprisingly simple. On one hand, section 1001(a) provides that gain or loss on a sale of property is measured by the difference between the amount realized and the taxpayer's basis in the property, and section 1001(b) defines the amount realized to include not only cash but also the fair market value of any property received.⁴ On the other hand, section 446 authorizes the taxpayer to choose generally between the cash and accrual methods of accounting for his income,⁵ while section 451 requires that items be included in

4. Section 1001 reads in relevant part as follows:

(a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized—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. . . .

(c) Recognition of Gain or Loss—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment Sales—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

5. Section 446 reads in relevant part as follows:

(a) General Rule—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) Permissible Methods—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

- (1) the cash receipts and disbursements method;
- (2) an accrual method;
- (3) any other method permitted by this chapter; or
- (4) any combination of the foregoing methods permitted under regulations described by the Secretary.

gross income in the year they are received unless properly accounted for as of a different period under the taxpayer's method of accounting.⁶ The problem is that when evidences of indebtedness of the purchaser are received by the seller in full or partial consideration of the sale, section 1001 yields results different from those obtained under either of the two standard methods of accounting.

The list of possibilities is best brought into focus by an example. Consider three taxpayers, *A*, *B*, and *C*, each of whom buys a 500-acre parcel of land for \$100,000 in cash in 1973. Taxpayers *A* and *B* hold their parcels for investment. Taxpayer *C* subdivides his property into 1000 one-half-acre lots and begins selling the lots in 1974 to individual purchasers for \$300 per lot. The sales are made under contracts providing for a 5% downpayment, with the balance to be amortized over five years in sixty equal monthly installments, including interest at 7% per annum on the unpaid balance. The contracts require *C* to deliver a deed covering the lots only when the balance is paid in full. By the end of 1977, *C* has sold all of his lots to installment purchasers.

In 1977 taxpayers *A* and *B* also dispose of their parcels. *A* sells to an individual purchaser for \$300,000 under a contract identical to that used by *C*—that is, 5% down (\$15,000) with the balance, including 7% interest, to be amortized over sixty months. *B* also sells his parcel for \$300,000, but the terms of sale are slightly more complicated. *B*'s purchaser gives *B* \$15,000 in cash and assigns to *B* the contractual promise of a third party to pay \$285,000 over the next sixty months, uniformly amortized together with interest at 7% per annum. By the end of 1977, then, *A*, *B*, and *C* have each received downpayments totaling \$15,000 from their respective sales plus payments of principal and interest in total amounts that vary with the dates of the sales. *C*, in fact, has been receiving these payments since his first sale in 1974. Assuming that none of the taxpayers elects to report gain under the installment method, the question is how each should be taxed under the Code. The discussion below outlines the variety of judicial approaches to taxing these transactions.⁷

(d) Taxpayer Engaged in More than One Business—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

6. Section 451(a) reads as follows:

(a) General Rule—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

7. The cases are discussed in text accompanying notes 51-149 *infra*.

A. *Taxation of A (isolated-sale purchaser obligation)—Accounting Method Governing.*

Taxpayer *A* sold his property to a single purchaser under a contract calling for deferred payment. The initial question is whether his method of accounting or section 1001 governs taxation of the transaction. First, assume that the court holds *A*'s accounting method, either accrual or cash, to govern.

1. *A on Accrual Method.* If *A* is on the accrual method and for simplicity we neglect interest payments, he must report the full \$285,000 face amount of the contract as income for 1977, even though he only received a \$15,000 cash downpayment plus whatever monthly payments were made in that year. His gain for 1977 would be the amount deemed received on the date of sale (\$15,000 + \$285,000 = \$300,000) less his basis of \$100,000, or \$200,000. The monthly payments actually received, whether in 1977 or later, have no tax effect except for interest.

2. *A on Cash Method.* If *A* is on the cash method, a subquestion arises whether the contract with the purchaser is a "cash equivalent."

(a) *Contract is a cash equivalent.* *A*'s income is the amount of cash he receives on the date of sale plus the amount of cash to which the purchaser contract is equivalent on that date, less *A*'s \$100,000 basis. Thus, if the contract is equivalent to \$235,000 in cash, *A* has a 1977 gain of \$15,000 plus \$235,000 minus \$100,000, or \$150,000. Receipt of monthly payments may or may not have a tax effect in 1977,⁸ but if all payments are made, *A* will sooner or later have to report an additional \$50,000 gain from the sale, as well as his interest income.

(b) *Contract is not a cash equivalent.* *A* first offsets his basis before reporting any gain. Because his basis is \$100,000, *A* has no gain from the sale to report in 1977, although he does have some interest income. The theory is that in 1977 *A* received both cash and the contract with the purchaser, but pursuant to the cash method of accounting, *A* only counts those contract payments that he actually received in 1977. In other words, section 451 authorizes *A* to treat receipt of the contract itself as of the later tax years in which the money payments are made. The 1977 payments, combined with the downpayment, are not sufficient to offset his basis. Under this approach, once *A* recovers his \$100,000 basis, the principal portion of each subsequent payment con-

8. See note 10 *infra*.

stitutes gain from the sale of property when received.

B. *Taxation of A—Section 1001 Governing.*

If, on the other hand, section 1001 is deemed to apply to *A*'s sale, a different series of subquestions arises. Recall that section 1001 defines the amount realized as money plus the fair market value of property received. *A* has still received cash plus a contract in 1977; the threshold question is then whether the contract is "property" under section 1001.

1. *Contract Treated as Other Than Property.* (a) *Amount realized calculated independently of accounting method.* If the contract is not property, one possibility is to treat the amount realized in 1977 as only the amount of cash *A* receives—the \$15,000 downpayment plus the principal portion of the monthly payments made in that year—without distinguishing between cash-method and accrual-method taxpayers. In this case, because the amount realized by the end of the year is lower than *A*'s basis, he has no gain in 1977. On the other hand, payments remain to be made on the contract, and therefore additional amounts remain to be realized. Only an intrepid taxpayer would argue that *A* has a *loss* in 1977, so the usual approach is to use the cash payments of principal received in 1977 to offset basis. Amounts received after *A*'s basis has been reduced to zero will then be considered amounts realized from the sale in the years they are received. At least for this transaction, applying section 1001 in this way yields the same result as treating *A* as a cash-method taxpayer.

(b) *Amount realized determined by accounting method.* Again assuming that the purchaser obligation is not treated as property, a second possible application of section 1001 focuses on the taxpayer's accounting method: If *A* is on the accrual method, the deferred-payment contract is treated as money equal to the face amount of the obligation. If *A* is on the cash method, however, the contract is treated as something other than property, but not as money either. The amount realized in 1977 is thus \$300,000 if *A* is on the accrual method but is only \$15,000 plus the principal portion of payments made during the year if *A* is on the cash method. The result for either type of taxpayer under this approach is exactly the same as if his method of accounting were applied to the transaction in the first instance.

2. *Contract Treated as Property.* If section 1001 applies and the purchaser contract is considered property within the meaning of the statute, the value of the contract is included in the amount realized

from the sale in 1977 because *A* received the property in that year. *A* has gain or loss in 1977 to the extent of the difference between his \$100,000 basis in the property and the sum of the amount he received on the date of sale (\$15,000 plus the fair market value of the contract on that date).⁹ The tax consequences of the sale then hinge on the ascertainability of that fair market value.

(a) *Fair market value not ascertainable.* If the contract has a value but the value is for some reason not ascertainable, the transaction must be held open because the "amount realized" needed to calculate gain or loss cannot be determined. Again, the result is exactly the same as if *A* is treated as a cash-method taxpayer for this transaction. Logically, one should note that this result should obtain even if *A* is on the accrual method, because by hypothesis section 1001, rather than the accounting provisions, applies.

(b) *Fair market value ascertainable.* The second possibility is to treat the contract as property under section 1001 and to find that it has an ascertainable value on the date of receipt. If, for example, the ascertained value of the contract is \$250,000, the amount realized in 1977 on the date of sale is the \$15,000 cash downpayment plus the \$250,000 value of the contract, a total of \$265,000. Subtracting *A*'s \$100,000 basis, he has a gain of \$165,000 to report as of the date of sale. Receipt of subsequent payments of principal under the contract may or may not have a tax effect in 1977.¹⁰ Sooner or later, however, *A* will have an

9. The open/closed transaction distinction under section 1001 has its roots in the requirement of an annual accounting for income. Theoretically it would not be necessary to decide the issue of fair market value until the end of the taxpayer's fiscal year. Nevertheless, the contract is usually physically received on the date of sale, and contractual rights begin on that date. As a result, this is the most logical time for its evaluation. Moreover, this choice is more consistent with the tradition of treating later repossessions of property as separate transactions. See text accompanying note 341 *infra*. Finally, the limited authority that exists seems to treat the date of sale as the relevant date. See, e.g., *Estate of Wiggins v. Commissioner*, 72 T.C. 701, 711 (1979). Because a different resolution of this issue would not change any of the analysis, this Article assumes that the date of sale is the date of closure of a closed transaction under section 1001.

10. Amortizing a \$285,000 principal over 60 months at 7% per annum gives equal monthly payments of \$5,643.34. The first payment consists of roughly \$1,662 in interest. Thus, if payments are made under the contract, *A* will receive approximately \$5,600 per month in principal and interest payments, assuming uniform amortization. The relative proportions of principal and interest in each payment will, of course, vary over the life of the payments, so let us assume for simplicity that, at least for 1977, the payments average \$4,000 per month in principal and \$1,600 per month in interest. If *A* receives six payments in 1977, he will then receive \$9,600 of interest income in that year and an additional \$24,000 of principal on the contract. *A*'s main problem in 1977, after the valuation is concluded, is how to account for this \$24,000.

The issues are subsidiary to the question of what Code provisions apply to the sale itself and may be briefly summarized: Because the \$285,000 face amount contract has been valued at \$250,000 and included in gross income, the first issue is whether the taxpayer may treat all of each

additional \$35,000 gain to report from the sale, as well as his interest income, assuming all payments under the contract are made.

C. *Taxation of B (isolated-sale third-party obligation).*

There is no obvious reason that the various methods courts have used for taxing *A*'s transaction could not also be applied to *B*, the taxpayer who took assignment of a third-party contractual obligation. Provided the quality of *B*'s obligor is the same as that of *A*'s, the two taxpayers are in essentially the same financial position. Nevertheless, no court has ever applied the taxpayer's method of accounting upon receipt of a third-party obligation. Furthermore, no court has ever held that such a third-party obligation is not property under section 1001. Instead, the question has been limited to whether the contract has an ascertainable fair market value. If it does not, the transaction remains open, as it would for *A*. If the contract has an ascertainable value, that value plus the \$15,000 cash downpayment, less basis, constitutes *B*'s gain from the sale in 1977.

D. *Taxation of C (regular-business purchaser obligation).*

Each of *C*'s sales between the years 1974 and 1977 may be treated in the same ways as *A*'s sale. The only difference between the two taxpayers is that *C* has many purchasers over several tax years and *A* has only one. No provision of the Code, however, expressly recognizes this distinction. If *C*'s accounting method governs, annual income for each of the years in question is determined simply by that method. That is, if *C* is on the accrual method, he must include in income the full face amount of each contract in the year of sale, with actual receipts under his contracts having no tax effect. If *C* is on the cash method, he must report payments as received, assuming the contracts are not cash equivalents.

On the other hand, the application of section 1001 may cause a tremendous administrative problem. If the contracts of sale that *C* entered into are property under section 1001, *C* (or the Service) must determine for each of the 1,000 contracts whether a fair market value is

\$4,000 principal payment as return of capital until the full \$250,000 basis in the obligation has been received and then treat the entire principal payments as income, or whether he must treat only 250/285 (roughly 88%) of each payment as return of capital and the remainder as income for the life of the contract. This issue arises because, if the contract is paid in full, *A* will receive a total of \$285,000 in principal, but he will have reported only \$250,000 as of the date of sale. The second issue is whether the payments that exceed \$250,000, regardless of how the timing issue is decided, constitute ordinary income or capital gain if the property sold was a capital asset in *A*'s hands. These issues are discussed in Part V of this Article. See notes 150-92 *infra* and accompanying text.

ascertainable. Furthermore, for each contract that has an ascertainable value, that value must be determined as of the date of each sale. Because the value of each contract will depend in part on the identity of the purchaser, a more onerous burden is difficult to imagine.

E. *Summary.*

Essentially all of the possibilities outlined above for taxing *A*'s and *B*'s gains have been followed, with or without any discernible rationale, by courts at one time or another. *C*'s case has not been litigated nearly as often, but even with so few cases the courts have failed to develop a unifying theory. Certainly no single rationale has been articulated that treats *A*, *B*, and *C* in a consistent way. Every potential solution raises new questions. For example, with an eye on avoiding the valuation problem presented by applying section 1001 to *C*, we might opt to rely solely on the methods of accounting in all disposition-of-property cases. It then becomes difficult to explain, however, the presence of section 1001 in the Code. We might therefore say that section 1001 always applies but in *C*'s case the value of the contracts is not ascertainable.¹¹ This approach solves that particular problem and gives *C* a nice windfall, but the result is difficult to justify when the quality and enforceability of *C*'s contracts are the same as *A*'s and *B*'s. If the value of the contracts is ascertainable, however, we face the highly unpalatable valuation problem. Finally, if one is to distinguish between *A* and *B*, on the one hand, and *C* on the other, presumably by applying section 1001 to *A* and *B* but the accounting provisions to *C*, one needs a rationale for the distinction.

Note that the analytical breakdown of the possibilities for taxing *A*, *B*, and *C* in this example depends in each case on whether the accounting provisions or section 1001 governs the measurement of income from the transaction in question. The concurrent development of so many different approaches is clearly the result of a judicial failure to recognize, let alone resolve, this choice. Had an adequate answer ever developed, many of these approaches would long since have died out as inconsistent. The next part of this Article attempts to discern the answer Congress intended in adopting these Code provisions.

III. STATUTORY DEVELOPMENT

A. *Development of the Statutory Scheme.*

A literal reading of section 1001 requires that any property re-

11. This was the approach of the Tax Court in *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979). See text accompanying notes 85-95 *infra*.

ceived on an exchange be included in income to the extent its fair market value plus any cash received exceeds the basis of the property exchanged.¹² The section makes no direct reference to the taxpayer's method of accounting.¹³ A basic question, therefore, is whether or to what extent the taxpayer's method of accounting impliedly modifies section 1001. The early development of the relevant statutory provisions and the accompanying congressional committee reports strongly suggest the original congressional intent.¹⁴

1. *Revenue Act of 1918.* The Revenue Act of 1918¹⁵ included the

12. Similarly, any loss would be measured by the difference between the basis of the property exchanged and the fair market value of the property received. The receipt of cash in addition to property usually has no effect on the analysis other than to change the magnitude of the numbers. Consequently, it saves words to refer to gain or loss simply as the difference between basis and the fair market value of the property received.

13. Section 1001(c) now reads: "Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized." One might at first blush read the "except as otherwise provided" clause to incorporate the provisions covering the allowable methods of accounting. However, this subsection is directly traceable to section 203(a) of the Revenue Act of 1924, in which the same clause read "except as hereinafter provided in this section." Ch. 234, § 203(a), 43 Stat. 253 (emphasis added). The next subsection of section 203 then provided for nonrecognition of gain in like-kind exchanges of business or investment property, reorganizations, transfers to controlled corporations, and certain involuntary conversions. A similar structure was retained through the Internal Revenue Code of 1939. Ch. 1, § 112, 53 Stat. 4. In 1954 the nonrecognition provisions were dispersed through several Code sections, so that it became necessary to change the word "section" to "subtitle." There is no indication, however, that anything other than this technical change was intended. See Levin & Javaras, *Receipt of Notes and Other Rights to Future Payments by a Cash-Basis Taxpayer*, 54 A.B.A.J. 405, 406 n.14 (1968).

14. The first income tax statute adopted after the passage of the sixteenth amendment contained no antecedent to current section 1001, its drafters being content to include in income gains from "sales, or dealings in property." Act of Oct. 3, 1913, ch. 16, § IIB, 38 Stat. 114. The statute also made no direct reference to accounting methods, although it seems clear that only the cash method was envisioned. This inference derives from the language concerning the permitted deductions: expenses "actually paid," interest and taxes "paid within the year," and losses "actually sustained." *Id.* In fact, with respect to the deduction for taxes, the word "accrued" in the Ways and Means Committee bill was stricken by the Senate Finance Committee and the word "paid" was substituted. See J. SEIDMAN 994.

The Revenue Act of 1916 added provisions to insure that gain or loss would be measured from a fixed basis on any sale or other disposition of property, thereby eliminating any doubt that Congress intended to tax all of the appreciation in a single year. Ch. 463, §§ 2(c), 5(a), 39 Stat. 756. An amendment adopted on the Senate floor would have taxed gain on the sale of real property only if the property were sold within two years of acquisition. The proponent of this amendment intended it to imply that the only gain taxable on the sale of personal property would be that which accrued in the year of sale. 53 CONG. REC. 13,407-08 (1916), reprinted in J. SEIDMAN 958-59. The Conference Committee eliminated this amendment and fixed March 1, 1913, as the basis-determining date for property acquired before that time. *Id.* 957-58.

The 1916 Act also expressly allowed for the use of an accrual method of determining income, although approval of the Secretary of the Treasury was required for any method other than cash receipts and disbursements. Ch. 463, § 8(g), 39 Stat. 756.

15. Ch. 18, 40 Stat. 1057 (1919).

first antecedent of present section 1001. Section 202(a) of that Act utilized a cost basis for determining gain or loss on "sales or other dispositions,"¹⁶ and section 202(b) covered exchanges: "When property is *exchanged* for other property, the property received *in exchange* shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any"¹⁷ Thus, section 202 expressly distinguished between the "sale or other disposition" transactions covered by 202(a) and the exchange transactions included in 202(b). In view of the contrast, a possible interpretation of section 202 could have been that the amount of gain or loss on a sale or other disposition, including an exchange, be determined by the basis provisions of subsection (a). The timing of gain recognition would be determined by the usual accounting methods, however, except in the case of an exchange, for which section 202(b) required taxation in the year of the exchange.¹⁸ One might then argue that the section 202(b) exchange provision covered a transfer of property in which the seller took obligations of the purchaser, so that the section would have taxed such obligations according to their market value in the year of the exchange.

This last step in the interpretation of section 202(b), however, is difficult to justify. It does not appear that Congress had sales for deferred-payment obligations in mind when it adopted the exchange provisions of section 202(b). Rather, the section appears to have been aimed at what might be termed "true exchanges," that is, transactions not otherwise clearly taxable as a sale, because it also excepted from recognition certain exchanges upon corporate reorganizations amount-

16. *Id.* § 202(a).

17. *Id.* § 202(b) (emphasis added). The Act also made clear that the taxpayer had an absolute right to use an accrual method of tax accounting, provided only that he kept his books the same way and that the method clearly reflected income. *Id.* § 212(b); see Appeal of Reubel, 1 B.T.A. 676, 678 (1925).

18. The property received was statutorily deemed a cash equivalent, and the receipt of cash was taxed in the year received under any method. The interpretation in the text below (namely, that section 202(b) did not apply to deferred-payment sales) may receive reinforcement from the concurrent adoption in the 1918 Revenue Act of the predecessor to current section 451, which provides that any item of gross income should be included in the year received unless properly accounted for as of a different period under the taxpayer's method of accounting. Ch. 18, § 213(a), 40 Stat. 1057. Thus, under the 1918 statute there was room to argue that section 202(b) should cover the case of taxpayer *B* in the example in Part II. See text accompanying notes 4-11 *supra*. By taking a third-party obligation as consideration for the transfer of property, *B* has made a section 202(b) exchange. On the other hand, accounting methods arguably should control the results under the 1918 statute for *A* and *C*, whose transactions were more like sales. Nevertheless, in view of the later development of the predecessors of section 1001 under the Revenue Acts of 1921 and 1924, which indicates that section 1001 governs both the amount of the gain *and* its timing, see notes 21-39 & 47-48 *infra* and accompanying text, the argument that section 451 modifies section 1001 as to timing now appears weak.

ing to "purely paper transactions."¹⁹ Thus, a sale for deferred-payment obligations of a purchaser might not have been an exchange within the meaning of section 202(b). These sales would therefore have been subject to recognition in accordance with the taxpayer's method of accounting.²⁰

2. *Revenue Act of 1921*. In any event, section 202 underwent important and illuminating changes in the next two major revisions of the federal income tax laws. In the Revenue Act of 1921,²¹ section 202(b) was totally revised to read: "For the 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 . . .*"²² The new subsection then went on to provide that even when the property received in exchange had a readily realizable market value, no gain or loss would be recognized on like-kind exchanges, certain defined corporate reorganizations, and transfers to controlled corporations.

The 1921 statute maintained the distinction between "sale or other disposition" in the basis-defining provisions and "exchange" in the recognition provisions. Indeed, the new reference to exchanges for other "such property" might be read as an attempt to emphasize the distinction between clearly taxable sales, as to which the only question was

19. S. REP. NO. 617, 65th Cong., 3d Sess. 5-6 (1918), *reprinted in* 1939-1 C.B. (pt. 2) 117, 120; *cf.* H.R. REP. NO. 1037, 65th Cong., 3d Sess. 44-45 (1919) (using similar language in connection with a related proposal), *reprinted in* 1939-1 C.B. (pt. 2) 130, 132. Nothing in the legislative history indicates that sale for a deferred-payment obligation was considered in the adoption of the recognition-on-exchange provisions of section 202(b). See J. SEIDMAN 789-801.

20. In the case of a transaction characterized as a sale, there is no question that a taxable event has occurred, and the only issue is timing. On the other hand, in the case of a true exchange not otherwise taxable as a sale, the transaction may go entirely untaxed unless tax is assessed in the year of the exchange.

Of course, the distinction between a sale and an exchange can be pushed so far that it gives undesirable results. For example, consider the treatment of a shareholder who exchanges his stock for some form of debt obligation of the purchasing corporation in a reorganization. If the reorganization fails to qualify for the nonrecognition exception of section 202(b), should he be taxed immediately to the extent of the full fair market value of the debt obligation received on the "exchange," when a cash-method taxpayer who simply "sells" corporate stock for the same debt obligation would have been taxed only as payments were made? Whatever the answer, the existence of problems with the distinction does not mean that the 1918 Congress did not attempt to make it.

21. Ch. 136, 42 Stat. 227 (1921).

22. *Id.* § 202(c) (emphasis added). In addition to revising the language of subsection (b) and changing its position to subsection (c), the 1921 Act also expanded subsection 202(a) to bring the basis provisions regarding property acquired prior to March 1, 1913, more explicitly in line with Supreme Court decisions. See S. REP. NO. 275, 67th Cong., 1st Sess. 10 (1921), *reprinted in* 1939-1 C.B. (pt. 2) 181, 187-88; H.R. REP. NO. 350, 67th Cong., 1st Sess. 9 (1921), *reprinted in* 1939-1 C.B. (pt. 2) 168, 175.

one of timing, and exchanges, only some of which were taxable but, when taxable, were to be taxed in full in the year of the exchange.²³ Unfortunately, nothing in the congressional history sheds any light on the intent of this new reference. It is clear, however, that Congress intended to limit drastically the taxability of exchanges. Although the 1918 Act treated anything received on an exchange as a cash equivalent unless specifically excepted, the 1921 Act reversed direction and taxed the transaction in the year of the exchange only when the property received had a readily realizable market value. Indeed, both the House²⁴ and Senate²⁵ committee reports indicate that the 1921 Act was intended to modify the existing presumption in favor of taxation.²⁶

3. *Revenue Act of 1924.* The Revenue Act of 1924²⁷ made another radical change concerning the taxation of sales and exchanges of property. For the first time the amount of the gain or loss was expressly defined, in section 202(a), as the difference between basis and the amount realized:

Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis . . . and the loss shall be the excess

23. There are other hints in the legislative history that section 202(c) covered only true exchanges. Both committee reports talked about the contemporary law's interference with "necessary business readjustments." S. REP. NO. 275, *supra* note 22, at 11-12, 1939-1 C.B. (pt. 2) at 188-89; H.R. REP. NO. 350, *supra* note 22, at 10, 1939-1 C.B. (pt. 2) at 175-76. Nothing indicates that anything classifiable as a sale was contemplated. In fact, during the Senate floor debate concerning the reorganization exception to immediate taxation of exchanges involving property with readily realizable market values, Senator Reed expressed concern that some types of reorganizations were more like sales than exchanges of property. He thought that they should perhaps be taxed as sales. 61 CONG. REC. 6568 (1921) (remarks of Sen. Reed), *reprinted in* J. SEIDMAN 796-97.

24. H.R. REP. NO. 350, *supra* note 22, at 10, 1939-1 C.B. (pt. 2) at 175-76.

25. S. REP. NO. 275, *supra* note 22, at 11, 1939-1 C.B. (pt. 2) at 188-89.

26. It is less clear precisely what was meant by the phrase, "readily realizable market value." The House bill originally required the property received on exchange to have a "definite and readily realizable market value" before tax would be assessed, but the Senate Finance Committee dropped the words, "definite and." J. SEIDMAN 789. The congressional materials give no reason for this change. It might imply that immediate recognition for tax purposes should not depend on whether the market value was ascertainable. Nevertheless, it seems more likely that the Senate Finance Committee's change was simply made to eliminate redundancy or, at most, to permit taxation even when the precise amount of the property's "readily realizable" value was in question. It is difficult to conceive of a readily realizable market value that is not ascertainable. Moreover, in the debate on the Senate floor, a suggestion was made that the word "realizable" be replaced with the word "ascertainable." Senator McCumber responded that something more than an abstract measurement of value was required for taxation. 61 CONG. REC. 6549 (1921) (remarks of Sen. McCumber), *reprinted in* J. SEIDMAN 792-93. The drafters therefore clearly intended a *realizable* value: if the exchange was to be taxable, one had to be able actually to sell the property received. Thus, a requirement for ascertainability was inherent in the 1921 test; the value had to be ascertained with respect to a market in which the property could readily be sold.

27. Ch. 234, 43 Stat. 253 (1924).

of such basis over the amount realized.²⁸

Section 202(c) defined the amount realized:

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.²⁹

Finally, section 203(a) provided for recognition of both sales *and* exchanges unless specifically excepted:

Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.³⁰

Section 203(b) retained the earlier statutes' exceptions for like-kind exchanges, reorganizations, and transfers to controlled corporations, and added a provision covering involuntary conversions.³¹ These three provisions are essentially identical to current sections 1001(a)-(c).

Two points stand out in a comparison of these new provisions with the prior law. First, Congress eliminated the provision in the 1921 statute providing that no gain would be recognized upon an exchange unless the property received had a readily realizable market value. The new statutes taxed property received on an exchange to the extent of its fair market value.³² The committee reports make it clear that the reversion to a fair market value standard was conscious,³³ and therefore it would be untenable that recognition of gain or loss on an exchange should depend on the existence of some sort of formal or ready market for the property received.³⁴ Second, these provisions eroded whatever justification prior law may have provided for different treatment of sales and exchanges. Whereas the ancestors of section 203(a) of the 1924 statute had covered only exchanges, this new recognition section

28. *Id.* § 202(a).

29. *Id.* § 202(c).

30. *Id.* § 203(a).

31. *Id.* § 203(b).

32. See text accompanying note 17 *supra*.

33. Both the House Ways and Means Committee and the Senate Finance Committee agreed that the requirement for a readily realizable market value was too indefinite to be applied with either accuracy or consistency. Thus, it would be better to provide for taxability of all exchanges, with specific and well-defined exceptions. These exceptions, of course, are covered by section 203(b). S. REP. NO. 398, 68th Cong., 1st Sess. 13-14 (1924), *reprinted in* 1939-1 C.B. (pt. 2) 266, 275-76; H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924), *reprinted in* 1939-1 C.B. (pt. 2) 241, 250-51.

34. Nevertheless, the courts have given little consideration to Congress's early efforts. See Haley, *The Application of Section 1001 to Deferred Payment Sales of Property*, 28 TAX LAW. 303, 305 (1975); Levin & Javaras, *supra* note 13, at 406. A number of courts have inquired into the existence of a market in determining both the timing and the extent of tax on the gain upon an exchange of property. See note 138 *infra* and accompanying text. The Ninth Circuit, however, recently analyzed the statutory development and concluded that ascertainability of fair market value was the sole requirement for triggering taxation under section 1001. *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 792 (9th Cir. 1975).

applied to both sales and exchanges. Congress's evident intent was that the amount of gain or loss would be determined by section 202(c) both for sales and for exchanges of property. It no longer could matter whether a sale for evidences of indebtedness of the purchaser was or was not considered an exchange.

Similar analysis indicates that the sale provisions of sections 202 and 203 covered timing as well as amount of recognition. Although section 203(a) required only recognition of the gain or loss and said nothing expressly about its timing, the statutory development discussed above indicates that recognition on an exchange took place in the year of the exchange under the predecessors of section 203(a). Indeed, for true exchanges there was no other potentially taxable event.³⁵ Now that both sales and exchanges were under the same umbrella, the gain from either a sale or an exchange involving the receipt of property would be taxed in the year of the transaction.³⁶

This analysis receives confirmation from the legislative history of the first provision for the installment method of reporting gain from the sale of property, section 212(d) of the Revenue Act of 1926.³⁷ That provision was aimed primarily at permitting installment reporting by dealers in personal property. It also allowed, however, for use of the

35. See note 20 *supra*.

36. The House Ways and Means Committee report stated 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*." H.R. REP. NO. 179, *supra* note 33, at 13, 1939-1 C.B. (pt. 2) at 250 (emphasis added). Almost identical language appears in the report of the Senate Finance Committee. S. REP. NO. 398, *supra* note 33, at 13, 1939-1 C.B. (pt. 2) at 275. The Ninth Circuit has read this language as implying taxation in the year of sale under section 1001. *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 792 & n.7 (9th Cir. 1975).

37. Ch. 27, § 212(d), 44 Stat. 10 (1926). Prior developments that led to the adoption of this section are also relevant to whether section 1001 and its predecessors were intended to cover timing as well as amount of gain on a sale of property. Subsection 202(f) of the Revenue Act of 1921, ch. 136, § 202(f), 42 Stat. 227, provided that section 202 should not be construed to prevent taxation of any payment under an installment contract in the year in which such payment was received. The legislative history under the 1921 Act gives no indication of the intent of this provision, although it seems likely that it was meant to endorse the regulations already adopted by the Service providing for installment reporting in certain cases. See generally 2 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 15.02 (1974).

In any event, the Board of Tax Appeals totally ignored section 202(f) a few years later when it ruled the regulations invalid as having no statutory foundation. *Appeal of B.B. Todd, Inc.*, 1 B.T.A. 762, 767 (1925). Section 212(d) of the Revenue Act of 1926 established a statutory basis in direct response to this ruling. S. REP. NO. 52, 69th Cong., 1st Sess. 19 (1926), *reprinted in* 1939-1 C.B. (pt. 2) 332, 346-47. Nevertheless, former section 202(f) has been preserved in precisely its original form and is now section 1001(d) of the current Code. It has been interpreted to except section 453 installment payments, and only these payments, from the general rule under section 1001 that gain is taxed in the year of sale. *Clodfelter v. Commissioner*, 48 T.C. 694, 703 (1967), *aff'd*, 426 F.2d 1391 (9th Cir. 1970). This interpretation would make little sense if section 1001 did not cover timing.

installment method for sales of real property and casual sales of personal property for a price exceeding \$1,000, provided in either case that the initial payments in cash or property other than evidences of indebtedness of the purchaser did not exceed 25% of the purchase price. The Senate Finance Committee was clear in its interpretation of the law applying to any sale that failed to qualify for installment treatment:

Deferred-payment contracts other than installment contracts are not affected by the committee amendment. When the initial payment exceeds 25 per cent 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*.³⁸

Finally, it should be noted that when the initial payment percentage was raised in 1928 from 25% to 40%, committees of both houses of Congress rejected an alternative proposal to provide for nonrecognition upon the receipt of installment obligations if no fair market value could be determined with reasonable certainty.³⁹

4. *Summary.* By 1926 the current provisions for taxing the sale or exchange of property had been adopted and seemed to require, when read in the light of their legislative history, exactly what they said. Gain or loss was to be recognized in the year of the sale or exchange, and the amount of gain or loss was the difference between the basis in the property given up and the fair market value of the property received. It made no difference whether the property received was cash, tangible property, intangible obligations of third parties, or evidences of indebtedness of the purchaser. At the same time, however, other provisions required that income be measured in accordance with either the cash or an accrual method of accounting.⁴⁰ Notwithstanding the considerable potential overlap between the sale-or-exchange provisions and the accounting provisions, there is little evidence that anyone

38. S. REP. NO. 52, *supra* note 37, at 19, 1939-1 C.B. (pt. 2) at 347 (emphasis added).

39. S. REP. NO. 960, 70th Cong., 1st Sess. 24 (1928), reprinted in 1939-1 C.B. (pt. 2) 409, 425; H.R. REP. NO. 2, 70th Cong., 1st Sess. 16 (1927), reprinted in 1939-1 C.B. (pt. 2) 384, 394. Both reports recommended no change in what they understood to be the existing Treasury Department practice of finding a fair market value in all cases in which a value was ascertainable.

40. Section 212(b) of the Revenue Act of 1926, ch. 27, § 212(b), 44 Stat. 10, was essentially identical to section 212(b) of the 1918 statute, cited in note 17 *supra*, and the intervening statutes. Prior to 1926 the courts had held that only the cash method or an accrual method was available. Appeal of B.B. Todd, Inc., 1 B.T.A. 762, 767 (1925); S. REP. NO. 52, *supra* note 37, at 19, 1939-1 C.B. (pt. 2) at 346; *cf.* Appeal of Reubel, 1 B.T.A. 676, 677-78 (1925) (congressional intent to provide accounting methods corresponding with taxpayers' own regular methods of accounting).

in Congress thought about the connection between them, except perhaps to the extent that installment reporting might be considered a method of accounting.⁴¹

B. *Interpreting the Current Statutory Framework.*

At the most abstract level of statutory interpretation, the sale-or-exchange provisions should prevail in all cases because they reached final form later than the accounting provisions and because they are aimed at a specific item of income—transactions in property—whereas the accounting provisions cover all types of income. However, even if courts had not decided otherwise by giving the accounting provisions precedence in many cases over the past fifty years, it is clear that the sale-or-exchange provisions could not have been intended to apply to all dealings in property.

Retail sales by a merchant provide a straightforward example of transactions that should not be subject to the sale-or-exchange provisions. To the extent the merchant sells for cash, of course, there is no difference in result among the cash method, the accrual method, and a literal application of section 1001. The amount realized is the amount of cash received, and all the gain is recognized in the year of sale. On the other hand, suppose the merchant sells on credit and, to take the simplest example, receives no cash in the year of sale. Under the cash method he has no income in that year;⁴² under the accrual method he has revenues measured by the full face amount of the purchaser's deferred-payment obligation; and under section 1001 he has income measured by the fair market value of the deferred-payment obligation. Even if the obligation bears interest, it is unlikely that a reasonable assessment of its fair market value will be either zero or the exact face amount of the obligation. Thus, section 1001 gives a result obtained by neither of the standard accounting methods. If section 1001 were to apply, however, a separate valuation would be required for each deferred-payment obligation received. These separate valuations would create an impossible burden for most businesses.

The short answer, of course, is that section 1001 was not intended to apply to regular sales of property as part of an ongoing business. Current regulations recognize this limitation on section 1001's scope:

41. See note 49 *infra*.

42. Under the current regulations the merchant would not be permitted to use the cash method because he would be required to calculate the cost of goods sold pursuant to an inventory recordkeeping system. He would therefore have to adopt an accrual method of accounting. Treas. Reg. § 1.446-1(c)(2) (1957); Treas. Reg. § 1.471-1 (1958). Nevertheless, the example serves to illustrate the relationship between the various methods of accounting and section 1001.

"If the vendor chooses *as a matter of consistent practice* to return the income from installment sales on an accrual method or on the cash receipts and disbursements method, such a course is permissible."⁴³ It is the reference to consistent practice that highlights the basic point. The requirement of consistency has always been fundamental to the accounting provisions of the Code.⁴⁴ More than one transaction is required, however, even to talk about consistency, and in the context of an accounting system, consistency makes little sense without a series of similar transactions. In the case of an ongoing business, consistency among the transactions insures that the primary distortion resulting from the choice of an accounting system will occur only in the first and last few years of operation,⁴⁵ and this minimal distortion may not be too high a price to pay for giving the taxpayer a choice of accounting (and therefore recordkeeping) methods. Excessive distortion usually occurs only when transactions are not sufficiently similar or numerous to make the application of an accounting method meaningful.

One possible approach is to interpret section 451 as the sole provision governing timing, leaving section 1001 to determine only the amount of gain in the particular year in which section 451 requires taxation. Under this approach, a cash-method taxpayer who sells property in exchange for a deferred-payment obligation of the purchaser receives, in the year of sale, property that would be included in section 1001's amount realized. Under section 451, however, his method of accounting properly calls for taxation in a later year.⁴⁶ The result of applying this approach to a cash-method taxpayer is that even the *amount* of his total gain from the sale is determined by his accounting method. The amount realized in later years is simply the cash received in those years. Consequently, the fair market value of the purchaser obligation is irrelevant, and section 1001 is without meaningful application.

The application of this approach to the accrual-method taxpayer is even stranger. The timing of recognition under section 451 is clear: his

43. Treas. Reg. § 1.453-1(e) (1958) (emphasis added).

44. See, e.g., *Connors, Inc. v. Commissioner*, 71 T.C. 913, 916 (1979); Treas. Reg. § 1.446-1(a)(2), -1(c)(1)(iv)(a), -1(c)(2)(ii), -1(d)(1) (1957).

45. For example, suppose that a manufacturer has one sale a year for 10 years of an item that he makes for \$1 and sells for \$2, and that he receives payment from each sale in the year following the sale. If he is on the accrual method, he will have an evenly spaced income of \$1 per year in years 1 through 10. If he is on the cash method, he will have an operating loss of \$1 in year 1, \$1 of income in years 2 through 10, and \$2 of income in year 11. His income in years 2 through 10 is the same under either method.

46. Receipt of a third-party obligation on a sale is arguably not "properly" covered by a cash accounting method, and this analysis serves to distinguish between taxpayers *A* and *B* in the example of Part II. See text accompanying notes 4-11 *supra*.

accounting method requires taxation in the year of sale, and in any event that is the year in which the contract is received. The amount of gain in that year, however, is less certain. If section 1001 governs, the fair market value and not the face value of the obligation is the measure of gain. This interpretation leads to the absurd result that accrual-method businesses must ascertain the value of every purchaser obligation received in regular business transactions. They may not rely on the face amount. Assuming this "absurdity" is avoided, this approach would then leave section 1001's fair market value standard with meaning, at most, only in the case of isolated sales by accrual-method taxpayers. For them, taxation would occur in the year of sale, but the amount of gain would be measured by the fair market value rather than the face value of the obligation.

This approach is obviously unsatisfactory. No court has ever adopted it, and the Service does not follow it.⁴⁷ This approach provides no justification for distinguishing isolated sales by accrual-method taxpayers from sales in the regular course of business. Nor is there any policy basis for its distinction in result for isolated sales by cash- and accrual-method taxpayers. Finally, the approach flies in the face of congressional intent as evidenced by the relevant legislative history.⁴⁸

The only reasonable view of the relationship between the accounting provisions and the sale-or-exchange provisions is that the former apply to the timing of gain from sales or exchanges in the regular course of business, while the latter apply without regard to the taxpayer's method of accounting in the case of isolated or casual sales. This interpretation would certainly not be inconsistent with the legislative history of the predecessors of the accounting provisions and section 1001⁴⁹ and would give both sets of provisions a meaningful role in tax-

47. See text accompanying notes 102-07 *infra*.

48. See notes 21-39 *supra* and accompanying text.

49. As discussed above, prior to 1924 the statutes defined the amount of gain from a sale or other disposition of property (presumably including exchanges of property) but contained an express recognition, or timing, section only for exchanges. See notes 15-26 *supra* and accompanying text. The exceptions to the recognition provision for exchanges, however, indicate that Congress envisioned reorganizations and other isolated events. In 1924 the recognition section was expanded to cover both sales and exchanges, but the exceptions remained similar. The inference, therefore, is still that the drafters had in mind major, isolated events. There is nothing in the legislative history to indicate that the recognition section covered sales in the ordinary course of business, and any intent to intrude on the established systems of accounting for business enterprises would surely have been more specific.

The inclusion of the installment sale provision with the other accounting provisions in section 212 of the Revenue Act of 1926 clearly indicates that Congress envisioned the installment sale provision as a third choice of accounting method. The legislative history accompanying the Act supports this interpretation. S. REP. No. 52 *supra* note 37. Moreover, this provision was intended

ing gain from the sale or exchange of property.⁵⁰ It would also go far toward eliminating the inconsistent and often irrational results stemming from the judicial confusion that has surrounded this issue for the past fifty years, a matter that is considered in the next Part.

IV. JUDICIAL INTERPRETATIONS

The intent of Congress, to the extent it can be determined, should always play an important role in interpreting federal statutes. However, in the case of Code provisions as old as the ones under consideration here, the relevance of even very strong evidence of congressional intent may be significantly diminished by an alternative judicial interpretation that clearly makes more sense as a matter of current tax policy. This is especially true when Congress has not acted to overturn the judicial approach. Accordingly, judicial alternatives should be analyzed to see whether any single interpretation has sufficient foundation in the Code and in tax policy to justify its adoption more uniformly.

It is important to remember that the primary problem under consideration involves sales of property in which an obligation of the purchaser is part of the consideration flowing to the seller. To be distinguished are transactions in which an obligation is received outside the sale-of-property context⁵¹ and sales transactions in which an obligation of a third party is part of the consideration. A brief analysis of these transactions will aid in evaluating the principal thesis of this Article.

to override the sale-or-exchange provisions with respect to the transactions to which it applied, simply because it otherwise makes no sense.

The installment method, however, unlike the cash and accrual methods, is not a true accounting system. It is impossible, for example, for a taxpayer to be solely on the installment method even in a single business because the method does not apply to losses or expenses. Consequently, it is supplementary to *both* the accounting provisions and section 1001. It ameliorates the effect of the basic accounting methods with respect to the regular dealings in personal property to which it applies, and it ameliorates the effect of section 1001 with respect to the other sales to which it applies. Therefore, the intrusion of the installment sale method into section 1001's domain of casual or isolated sales does not provide a ground for a similar intrusion of either of the two basic accounting methods.

50. This approach will, of course, require development of a workable definition of casual or isolated transactions and will necessitate a case-by-case factual evaluation of the fair market value of purchaser obligations received in these transactions. The first problem, however, appears to be soluble, see notes 158-64 *infra* and accompanying text, and the second is not unique, see notes 164-92 *infra* and accompanying text.

51. An example of this type of transaction would be compensation for services.

A. *Third-Party Obligations and Non-Sale-or-Exchange Cases Distinguished.*

1. *Third-Party Obligations.* Courts have had little theoretical or practical difficulty in handling cases in which the seller of property⁵² receives an obligation of a third party from the purchaser.⁵³ Few if any courts have even considered the taxpayer's accounting system in these cases: they have treated the third-party obligation just like a piece of tangible property received on an exchange and have included it in the amount realized at its fair market value.⁵⁴ The theory presumably is that, as between seller and buyer, the transaction is at an end.⁵⁵ In any

52. For convenience, the term "seller" will be used to refer to the person who has given property in exchange for something else and whose taxation is under analysis. The other party to the transaction will be referred to as the "buyer" or "purchaser." This terminology may be used even when the transaction involved might be characterized more accurately as an exchange than as a sale. A promise or obligation of the purchaser, given to the seller as consideration for the transfer, to pay money directly to the seller in the future will be referred to as a "purchaser obligation."

53. This is the case of taxpayer *B* in the introductory example. See text accompanying notes 4-11 *supra*.

54. Corporate liquidations and redemptions of corporate stock are the most typical situations in which third-party obligations are received. The courts usually accept the Service's position that property seldom lacks an ascertainable fair market value. See *Slater v. Commissioner*, 356 F.2d 668, 670 (10th Cir. 1966); *Campagna v. United States*, 290 F.2d 682, 684 (2d Cir. 1961); *Estate of Marsack v. Commissioner*, 288 F.2d 533, 536 (7th Cir. 1961); *Chamberlin v. Commissioner*, 286 F.2d 850, 852-53 (7th Cir.), *cert. denied*, 368 U.S. 820 (1961); *Gersten v. Commissioner*, 267 F.2d 195, 198 (9th Cir. 1959); *Kuehner v. Commissioner*, 214 F.2d 437, 441 (1st Cir. 1954). The *Kuehner* court used cash-equivalence analysis to tax a stock redemption in the year of sale when the purchase price was placed in an unconditional escrow account with instructions that it be paid out over a five-year period. This result is correct but somewhat shallow in its reasoning: the unconditional escrow is no more than an obligation of the third-party escrow agent, and cash-equivalence analysis is relevant at most only to value.

An approach that requires evaluation of third-party obligations under section 1001 receives further statutory support from the rule that the installment method may only be used if payments during the initial year amount to less than 30% of the total purchase price. By excluding evidences of indebtedness of the *purchaser* from the 30% calculation, the Code makes it clear that an evidence of indebtedness of a third party must be considered a payment. § 453(b)(2)(B); see *Tombari v. Commissioner*, 299 F.2d 889, 891-92 (9th Cir. 1962); *Simpson v. Commissioner*, 35 T.C.M. (CCH) 710, 717 (1976).

55. This theory for taxation is of considerable importance outside the area of property sales when no express statutory provision governs the timing of income receipt. An example would be compensation for services. Both casual and regular transactions presumably must be fit into the taxpayer's accounting method. If the employer pays for services with tangible property—real estate or a diamond ring—the employee has income to the extent of the property's fair market value. *Treas. Reg. § 1.61-2(d)(1)* (1957). However, because the Code has always permitted the cash method of accounting for income, no justification exists for taxing a cash-method employee on the receipt of an employer obligation that is not a cash equivalent. *Cf. Schlemmer v. United States*, 94 F.2d 77 (2d Cir. 1938) (note taken in connection with performance of services is not income, unless equivalent to cash) (alternative rationale).

The tension between these two black-letter principles is not resolved by saying that tangible property is equivalent to cash. First, this distorts the statutory language, because one cannot

event, the cash and accrual methods of accounting and the approach taken by section 1001 lead to identical results in cases of this type.⁵⁶

One problem not yet fully resolved is that raised by the famous

"spend" real estate or diamond rings for groceries. In addition, it fails to explain the immediate taxation, to the extent of their fair market value, of non-cash-equivalent third-party obligations received in an employment context. *See, e.g.,* *United States v. Drescher*, 179 F.2d 863, 865 (2d Cir.) (third-party annuity contract purchased by employer is income to employee in year of purchase to extent of its fair market value), *cert. denied*, 340 U.S. 821 (1950). A few courts have attempted to resolve the problem by considering whether the employee has received an economic benefit, *e.g.,* *Goldsmith v. United States*, 586 F.2d 810, 820-22 (Ct. Cl. 1978), but this test still seems to miss the basic point. An unfunded deferred compensation agreement with General Motors can be characterized as cash only through a legal fiction. The agreement does, however, have some economic value to the employee, even if the agreement is nontransferable. At the very least, his creditworthiness improves. An obligation received from an employer is not, by virtue of its origin, any less like cash than a comparable obligation of a third party of equal solvency. Yet such an agreement is not taxed on receipt. *See Robinson v. Commissioner*, 44 T.C. 20, 36-37 (1965), *acq.* 1970-2 C.B. xxi, 1976-2 C.B. 4 n.10; Rev. Rul. 60-31, 1960-1 C.B. 174, 178.

A more appropriate reason to distinguish employer obligations from third-party obligations may be the practical notion that when an employee agrees to accept a third-party obligation in return for his services, his relationship with his employer, as to that item of income, is at an end. *Cf.* Rev. Rul. 73-173, 1973-1 C.B. 40, 41 (right to breed a stallion once a year received for services is not immediately taxable if contingent on performance of future services, *i.e.*, if the employment relationship has not ended). The employer gives up much if not all of his power to effect self-help remedies, and the employee need only look to the third party, who if solvent is unlikely to have any defenses. Like the diamond ring or other tangible property that may not be easily marketable, the employee has accepted something of value, and the year of receipt seems the most appropriate time to tax him on his income. The only issue is the extent of the value.

In the case of a sale or exchange of property, a rationale that looks to the termination of the parties' transaction is unnecessary and indeed may even be inappropriate. In this case section 1001 provides an adequate statutory basis for analysis. Of course, when the taxpayer receives tangible property in exchange, or even intangible property that represents something more than an obligation to pay money in the future (a share of stock, for example), the property received must be evaluated and tax assessed in the year of the exchange. Otherwise, taxation may be postponed indefinitely—that is, until the taxpayer or his heirs or donees dispose of the property received. However, when a third-party obligation to pay money in the future is received, it is not clear that the operative principle resulting in immediate taxation should be the end of the transaction between buyer and seller. It might be simpler administratively to let the taxpayer rely on an analogy to either the cash or accrual method of accounting, assuming such reliance does not distort income, particularly when the taxpayer receives third-party obligations on a regular basis in his sales business. This treatment would eliminate the need for an individual evaluation of the obligations received.

Moreover, when the third-party obligation is guaranteed by the buyer, the transaction between buyer and seller is far from over, at least in principle. In this case, the seller must look first to the third party for satisfaction of the obligation (a requirement that is eliminated by contract in many modern guarantees), and the seller is likely to be in a stronger position in case of the buyer's insolvency. It is not clear, however, why either of these distinctions should affect the taxation of the seller. A much more satisfactory principle of taxation would rely on section 1001 properly interpreted to apply only to casual or isolated transactions. Under section 1001 both third-party obligations and purchaser obligations should be included in the amount realized from isolated transactions to the extent of their fair market values.

56. *See Denver & R.G.W.R.R. v. United States*, 318 F.2d 922, 924 n.1 (Ct. Cl. 1963).

case of *Burnet v. Logan*:⁵⁷ what should be done when the value of the third-party obligation is highly speculative? Most decisions seem to recognize, at least implicitly, that essentially all obligations to pay money in the future, however conditioned or uncertain in amount or timing, have some ascertainable value.⁵⁸ A few courts, however, have found that particular third-party obligations had no ascertainable fair market value, thereby blessing the taxpayers involved with all the well-known benefits of an open transaction.⁵⁹ Nevertheless, whether a particular obligation has an ascertainable fair market value is a question of fact and therefore is without precedential value. For this reason, these cases are of little assistance to other taxpayers eager for similar treatment, and the theoretical error underlying them seems so evident that few taxpayers are able to rely on them. Except for truly unusual situations,⁶⁰ these cases probably only permit taxpayers to file returns reporting gain on the open-transaction approach without fear of being prosecuted for fraud, the real hope always being that the particular return will not be carefully audited.⁶¹ In any event, the important point

57. 283 U.S. 404 (1931). *Logan* involved a direct obligation of the buyer and not of a third party, but it is the case on which all subsequent recipients of third-party obligations have pinned their hopes.

58. See note 54 *supra* and the cases cited therein. *Cf.* Levin & Javaras, *supra* note 13, at 406 (courts may eventually hold nonforfeitable deferred compensation payments to be income at time services are performed if a market develops so that cash-basis taxpayers could readily sell or borrow against their written contracts).

59. *E.g.*, *Dorsey v. Commissioner*, 49 T.C. 606, 629-30 (1968) (royalty contract owned by corporation distributed to taxpayer on liquidation); *cf.* *Estate of Williamson*, 29 T.C. 51, 60 (1957) (sale of stock under stipulation that proceeds of sale be loaned to corporation on open account, with result that taxpayer received obligation of someone other than purchaser in exchange for his stock), *acq.* 1958-2 C.B. 8. Both *Dorsey* and *Williamson* evoked strong dissents. In a few other cases the Service either stipulated to or failed to argue against the proposition that the third-party obligations received by the taxpayer had no ascertainable fair market value. *E.g.*, *Westover v. Smith*, 173 F.2d 90, 91 (9th Cir. 1949); *Commissioner v. Carter*, 170 F.2d 911, 912 (2d Cir. 1948); *see Rev. Rul. 58-402*, 1958-2 C.B. 15, 16.

In these cases the theory necessarily is that the property received has value but that the value is not ascertainable. The taxpayer therefore has income only when cash receipts have exceeded his basis in the obligation; that is, the transaction remains "open." *Id.*, 1958-2 C.B. at 17. If, however, the property received actually has zero value, the difference between that value and, say, \$1 or \$1,000 is only one of degree. The obligation presumably should be included (at zero) as part of the amount realized in a closed transaction in which gain or loss is completely and finally recognized.

60. A possible example is given in M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 245-46 (2d ed. 1979).

61. Proposals have been made to reduce incentives for the taxpayer to try this method of reporting when he has received a direct obligation of the purchaser in a property sale. The proposals would require the taxpayer to make an affirmative election to report gain under section 1001. If no election were made, the installment sale provisions would apply. If an election were made, the Service would be on notice that an audit might be appropriate. See text accompanying notes 278-79 *infra*. Even if this proposal were adopted, however, the opportunity to try for open-

for present purposes is that because most if not all of the reported third-party obligation cases have involved isolated transactions, their reliance on section 1001 is consistent with the approach advocated in this Article.

2. *Non-Sale-or-Exchange Cases.* The taxpayer's accounting method generally governs the timing of income recognition from transactions not involving the disposition of property. No specific timing provision analogous to section 1001 normally covers these transactions.⁶² For example, in the case of compensation for services,⁶³ dividends,⁶⁴ and rental payments under a lease of property,⁶⁵ the Service and the courts agree that an obligation from the employer or the other party to the transaction⁶⁶ will be included in the income of a cash-method taxpayer⁶⁷ in the year of receipt only if the right is a cash

transaction treatment for a third-party obligation would probably remain. No one is proposing that installment reporting of gain from these sales be permitted. See note 191 *infra*.

62. There are, of course, special timing provisions governing certain specific non-sale-of-property transactions. *E.g.*, § 83 (transfer of property in connection with the performance of services); § 421 (exercise of qualified stock options).

63. *Vestal v. United States*, 498 F.2d 487, 493-94 (8th Cir. 1974); *Edelman v. United States*, 329 F.2d 950, 954 (Ct. Cl. 1964); Rev. Rul. 73-173, 1973-1 C.B. 40.

64. *Denver & R.G.W.R.R. v. United States*, 318 F.2d 922, 928 (Ct. Cl. 1963) (nontransferable car note issued as dividend giving right to take railroad sleeping cars immediately or cash in a later year, at choice of recipient, has value in year of receipt measured only by present right to receive sleeping cars and not by amount of cash receivable in a later year, notwithstanding sound financial condition of issuer); *Omholt v. Commissioner*, 60 T.C. 541, 549 (1973) (negotiable demand promissory note issued to controlling shareholder held to be dividend taxable as such only when cash payment on note was received; there was evidence that corporation was financially unable to pay any more cash than it did), *acq.* 1974-2 C.B. 4; *Vinnell v. Commissioner*, 52 T.C. 934, 944-45 (1969) (sale of sister corporation stock to controlled corporation under long-term contract held to be dividend under section 304(a)(1) only as payments were made on contract). *But cf.* *Kerr v. Commissioner*, 326 F.2d 225, 228 (9th Cir.) (affirming finding of dividend in year of redemption on facts similar to *Vinnell*, but timing issue apparently not argued), *cert. denied*, 377 U.S. 963 (1964).

Similarly, corporate assumption of a shareholder's liability is a dividend to the shareholder only when he is actually relieved of liability. If the shareholder remains secondarily liable on the debt, his liability will be relieved only when the debt is paid. *Maher v. Commissioner*, 469 F.2d 225, 229 (8th Cir. 1972); *Kleeden v. Commissioner*, 3 T.C.M. (CCH) 1122, 1125 (1944); Rev. Rul. 77-360, 1977-2 C.B. 86, 87.

65. *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961); Rev. Rul. 68-606, 1968-2 C.B. 42.

66. Of course, a third-party obligation received in any of these contexts will almost invariably be included in current income. The only issue the courts have recognized is whether the obligation has an ascertainable fair market value. *See, e.g.*, *Coffey v. Commissioner*, 14 T.C. 1410, 1419-20 (1950) (contingent right to payment issued as dividend will be taxed to extent of its fair market value). See notes 54-61 *supra* and accompanying text.

67. In principle, a taxpayer using the accrual method in his primary business should be able to use the cash method for unrelated and isolated transactions. The regulations permit the use of different methods for different businesses. The only requirement is that once a method is chosen for a particular business, it must be followed consistently thereafter. Treas. Reg. § 1.446-1(d)(1)

equivalent. The test used to determine cash equivalence is whether the right is both freely transferable and readily marketable. Courts that have imported the concept into the disposition-of-property area have used a much broader definition of cash equivalence, but the narrow test is clearly appropriate. If the taxpayer has to go far outside his usual commercial channels to convert the item into cash, to treat it as a cash equivalent is really to deny the cash method as to that item. The broad definition of cash equivalence thus runs counter to the express provisions of the Code allowing the use of the cash method of accounting.⁶⁸ The Service is authorized to deny the cash method when it does not

(1957). The cases and rulings usually classify the taxpayer as cash method or accrual method without considering that he might use a combination system. Nevertheless, whether an accrual-method taxpayer in his regular business uses a combined system should presumably depend on how he accounts for the first item of his income unrelated to his accrual business, because from that time forward the method must be followed consistently. The cash method generally delays liability for taxes, so a taxpayer should probably retain the cash method for isolated and unrelated items of income when he starts a business requiring accrual-method accounting.

68. There is, of course, a need to qualify the cash method to prevent its abuse. This is accomplished by the cash-equivalence rule and the related doctrine of constructive receipt. The regulations provide that income is constructively received if payment is made available to the taxpayer, that is, if he can draw upon it at any time. Treas. Reg. § 1.451-2 (1957). An item is supposedly not constructively received if actual receipt is subject to substantial limitations or restrictions. *Id.* Examples of constructive receipt and cash equivalence illustrate the theoretical difference between the two concepts: actual receipt of a piece of paper promising to pay money in the future is analyzed in terms of whether the paper is a cash equivalent; a letter stating that the money is ready for the taxpayer to pick up whenever he chooses is analyzed in terms of constructive receipt. The letter is clearly not a cash equivalent.

The problem in distinguishing between the two doctrines usually arises in contractual arrangements pursuant to which the taxpayer agrees to accept payment at a time later than the time at which he would normally be paid. For example, in the deferred-payment context, the taxpayer may agree with his employer to forego part of his salary in return for the employer's promise to make the payments at a future time. Arguably, if the employer does not care when payment is made and the agreement is made solely to satisfy the personal desires of the taxpayer, the money has actually been made available to him and the only limitations are of his own making. Therefore, the deferred payments in this situation could be deemed constructively received in the year they are earned. It now seems clear, however, that the taxpayer can escape the constructive receipt doctrine by providing for later payment in an arm's-length contract. *Goldsmith v. United States*, 586 F.2d 810, 817 (Ct. Cl. 1978); *Robinson v. Commissioner*, 44 T.C. 20, 36-37 (1965), *acq.* 1970-2 C.B. xxi, 1976-2 C.B. 4 n.10; *cf.* *Amend v. Commissioner*, 13 T.C. 178, 185 (1949) (taxpayer's contract calling for deferred payment held to be arm's-length, so that constructive receipt doctrine did not apply), *acq.* 1950-1 C.B. 1; Rev. Rul. 60-31, 1960-1 C.B. 174, 178 (additional compensation to be received under employment contract includible in gross income only in taxable years in which taxpayer actually receives installment payments in cash or other property previously credited to his account).

The taxpayer in this situation *has* actually received something, however: a promise to pay in the future. If it is the promise of a third party, it will be taxed to the extent of its ascertainable fair market value. See notes 54-60 *supra* and accompanying text. Even if the promise is from the other party to the transaction, the question of cash equivalence, provided the taxpayer's method of accounting governs timing, remains.

clearly reflect income,⁶⁹ and this is a more proper ground for action in particular cases than is a general expansion of the cash-equivalence concept.

B. *Judicial Approaches in Purchaser-Obligation Cases.*

The law thus seems clear that section 1001 applies to third-party obligations received in connection with a sale of property, while the taxpayer's method of accounting covers obligations of the other party to the transaction in non-sale cases not specifically covered by some other provision of the Code. The real confusion centers on the receipt of purchaser obligations in connection with a disposition of property. The source of the confusion is undoubtedly section 1001 itself, which creates a tension between the general accounting provisions of the Code and its own specific requirements in the case of a sale or exchange of property. The problem is to resolve this tension by a statutory interpretation that gives meaningful effect to the specific sale-or-exchange provisions under section 1001 and the accounting provisions under sections 446 and 451.

Nevertheless, despite more than fifty years of litigation between hundreds of taxpayers and the government, essentially no court has analyzed the problem in these terms.⁷⁰ The Service has added to the confusion by adopting a mixture of the various judicial lines, usually seeking to apply the taxpayer's method of accounting to accrual-method taxpayers but section 1001 to cash-method taxpayers. The Service has not, however, articulated a rationale for the distinction.⁷¹

69. § 446(b).

70. Judge Fay of the Tax Court, in a recent dissent, explicitly noted the potential conflict between the accounting rules and section 1001, but he resolved the conflict by looking solely to whether the obligation in question was a cash equivalent. *212 Corp. v. Commissioner*, 70 T.C. 788, 808 & n.9 (1978) (Fay, J., dissenting). Because cash equivalence is an accounting provision (cash-method) concept, Judge Fay thereby implicitly assumed that the accounting rules always govern. See text accompanying note 116 *infra*.

71. The Service's best and most recent effort in this regard is Rev. Rul. 79-292, 1979-39 I.R.B. 18, in which the Service held that an accrual-method corporate taxpayer in the construction business had to include in income the full face amount of two long-term purchaser obligations received in connection with the sale of a home (presumably one built by the taxpayer) and of equipment used in the taxpayer's business. Because the taxpayer was in the construction business, application of its method of accounting appears correct in terms of the approach suggested in this Article.

The ruling, however, contains the same inconsistencies and shallow analysis that have pervaded this area from its inception. The Service first states, with no authority other than examples contained in its own regulations, that section 1001 applies to both casual sales and sales in the ordinary course of business. *Id.*, 1979-39 I.R.B. at 19. It goes on to conclude, without citing statutory language or legislative history, that purchaser obligations are treated as money to an accrual-method taxpayer under section 1001(b). *Id.* It then states that section 1001(b) is implicitly subject to the taxpayer's method of accounting, *id.*, although if this were the case, there would be

Moreover, attorneys for the Service have always felt free to deviate from the official position of the Service in their efforts to win particular cases.⁷² The result is an array of distinct lines of authority.

1. *Literal Application of Section 1001.* Some courts have applied section 1001 and its predecessors literally, without regard to the taxpayer's method of accounting.⁷³ The unexpressed basis of statutory in-

no need for the fictionalized treatment of the obligation as money to accrual-method taxpayers. Moreover, the ruling then formulates the prescription for the section 1001(b) amount realized by cash-method taxpayers—cash plus the fair market value of the obligation—without discussing whether the obligation is a cash equivalent. *Id.* If the obligation is not a cash equivalent, however, the taxpayer's method of accounting would require inclusion in income only at the time cash or its equivalent is received.

72. The Service has long taken the view that in any sale of real property by cash-method taxpayers not eligible for installment sale treatment, obligations of the purchaser are the equivalent of cash to the amount of their fair market value. T.D. 3921, V-2 C.B. 24, 27 (1926). This view was extended by analogy to cover personal property as well. G.C.M. 1387, VI-1 C.B. 48, 50 (1927), *declared obsolete*, Rev. Rul. 69-31, 1969-1 C.B. 307. These early rulings left open the possibility that property received might well not have a fair market value, and in a number of cases the Service so held. G.C.M. 1387, VI-1 C.B. 48 (1927) (contractual promise to pay not evidenced by note or similar obligation is not a cash equivalent); G.C.M. 1215, VI-1 C.B. 195 (1927) (second mortgage taken by vendor of real property to secure payment of purchase price had no fair market value). However, by the 1930s the Service generally was taking the position, with partial success, that *whatever* was received by the seller had a fair market value and was therefore includable in income in the year of sale. *See, e.g.*, *Whitlow v. Commissioner*, 82 F.2d 569, 574 (8th Cir. 1936) (Service successful in taxing unsecured notes received upon sale of real property at face value in year of sale, despite absence of any ready market for the notes); *Kleberg v. Commissioner*, 43 B.T.A. 277, 289 (1941) (arguing unsuccessfully that contractual promise to pay for property transferred was includable in income of cash-method taxpayer in year of sale), *acq. withdrawn* 1952-1 C.B. 5; *Gillies v. Commissioner*, 20 B.T.A. 570, 572 (1930) (open account payable of solvent vendee corporation held to have fair market value and therefore taxable to vendor in year of sale).

The Service's official view today is similar to that developed in the 1920s and 1930s, but it now states that property received will lack an ascertainable fair market value "only in rare and extraordinary cases." Treas. Reg. § 1.453-6(a)(2) (1967); Treas. Reg. § 1.1001-1(a) (1957). In some cases, however, the Service would, and still does, reverse its own position. The Service will argue, for example, that property received by the seller had *no* fair market value in the year of sale when the statute of limitations has run with respect to that year, so payments received on the purchaser obligation in later years are subject to taxation. *E.g.*, *Holbrook v. Commissioner*, 34 T.C.M. (CCH) 1283 (1975); *Eckstein v. Commissioner*, 4 T.C.M. (CCH) 893 (1945). These inconsistent positions sometimes backfire against the Service, but that does not alleviate the confusion they cause. See note 117 *infra* and accompanying text.

73. *See In re Steen*, 509 F.2d 1398, 1404-05 (9th Cir. 1975); *Dennis v. Commissioner*, 473 F.2d 274, 285 (5th Cir. 1973) (dictum); *Clodfelter v. Commissioner*, 426 F.2d 1391, 1395 (9th Cir. 1970); *Heller Trust v. Commissioner*, 382 F.2d 675, 680-81 (9th Cir. 1967); *Riss v. Commissioner*, 368 F.2d 965, 970 (10th Cir. 1966); *Doric Apartment Co. v. Commissioner*, 94 F.2d 895, 896 (6th Cir. 1938); *Whitlow v. Commissioner*, 82 F.2d 569, 571-72 (8th Cir. 1936); *Starker v. United States*, 432 F. Supp. 864, 869 (D. Or. 1977), *modified on other grounds*, 602 F.2d 1341 (9th Cir. 1979); *Caruth v. United States*, 411 F. Supp. 604, 608 (N.D. Tex. 1976), *rev'd on other grounds*, 566 F.2d 901 (5th Cir. 1978) (dictum); *McCormac v. United States*, 424 F.2d 607, 618-19 (Ct. Cl. 1970); *Owen v. United States*, 8 F. Supp. 707, 710-11 (Ct. Cl. 1934); *Witte v. Commissioner*, 31 T.C.M. (CCH) 1137, 1142-43 (1972), *rev'd on other grounds*, 513 F.2d 391 (D.C. Cir. 1975) (stipu-

terpretation is presumably that the specific and more recently adopted provision overrides the general. None of these courts distinguishes between regular and casual sales, although the cases include examples of both types of sales. Nor have these courts considered security for the obligation, financial solvency of the purchaser, or degree of marketability of the obligation as relevant to the analysis except in determining the obligation's fair market value. The Tax Court, in fact, has taken the literal approach to section 1001 in several cases involving unusual fact situations, even in the face of a special Code section or revenue ruling intended to be ameliorative.⁷⁴ Once the court determined that

lation); *Rubino v. Commissioner*, 8 T.C.M. (CCH) 1095, 1099 (1949), *aff'd per curiam on other grounds*, 186 F.2d 304 (9th Cir. 1951); *Robinson v. Commissioner*, 28 B.T.A. 788, 792 (1933), *rev'd on other grounds*, 73 F.2d 769 (9th Cir. 1934); *Gillies v. Commissioner*, 20 B.T.A. 570, 572 (1930).

74. One example is private annuities. In *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973), stock worth \$207,000, but with a basis to the two taxpayers of only \$21,000, was transferred to relatives for an annuity—a promise to pay \$1,000 per month for as long as either taxpayer remained alive. The court valued this annuity at \$126,000 and therefore concluded that the taxpayers had made a gift of \$81,000 (\$207,000-\$126,000) to the relatives and had a gain of \$105,000 on the exchange. The taxpayers' "investment in the contract," for the purpose of applying the exclusion ratio to the annuity provisions under section 72, was found to be \$126,000. Thus the taxpayers essentially obtained the treatment they had sought on this issue. The finding of a high investment in the contract meant that a high percentage of each payment would be excluded from income. However, taxpayers also sought to report their gain on the cost-recovery approach, and the court denied them this treatment. *Id.* at 473-75. The taxpayers were therefore subjected to a very heavy tax burden in the year of the transfer and certainly received insufficient cash from the transaction itself to cover the assessment.

The Service in *Bell* had sought to apply Revenue Ruling 69-74, 1969-1 C.B. 43, which would fix the taxpayers' investment in the contract at the lower value of the taxpayers' basis in the stock transferred, thereby decreasing the exclusion ratio. At the same time, however, the ruling would permit the taxpayers to report the \$105,000 gain ratably over their combined life expectancy. Consequently, a higher percentage of each annuity payment would represent gain, but a ratable portion of the gain would be capital gain for the period of the taxpayers' life expectancy, and the taxpayers would have no immediate recognition of gain from the exchange. In this sense, the revenue ruling would have ameliorated the harsh effect of section 1001, although it would also have retained the exclusion ratio previously calculated even with respect to payments made after the taxpayers outlived their original life expectancy. *Id.*, 1969-1 C.B. 44. Because the taxpayers really *did* pay \$126,000 for their annuity, the sizable increase in ordinary income that would result from the ruling might be considered an unfairly high price for the benefit of ratably reporting the gain. The dissent in *Bell* would have given the taxpayers the benefits of ratably reporting coupled with the value of the higher investment in the contract, essentially by judicial fiat. 60 T.C. at 478-79 (Simpson, J., dissenting).

The *Bell* holding was reaffirmed in *212 Corp. v. Commissioner*, 70 T.C. 788 (1978). A dissent in *212 Corporation* would also have adopted an installment method of reporting the gain, by analogy to other regulations outside the sale-of-property area. *Id.* at 813-14 (Simpson, J., dissenting). In neither *Bell* nor *212 Corporation* did the majority opinion even refer to, let alone distinguish, the long line of cases cited in the dissents holding that a cash-method taxpayer need not report income from an exchange unless the purchaser obligation received is a cash equivalent. Nevertheless, it is difficult to imagine a contractual obligation to pay money in the future that is less like cash than is a nontransferable private agreement to pay a fixed monthly sum for the lifetime of a particular individual.

Other unusual situations can occur when one of the statutory exceptions to recognition of

the ameliorative provision was inappropriate, it applied section 1001 harshly, giving no consideration to the other lines of authority under section 1001 that could have softened the blow.⁷⁵

2. *No-Ascertainable-Fair-Market-Value Approach.* Another group of decisions rests on a similar theory in purporting to apply section 1001 or its predecessors, but these courts arrive at a different result by finding that the purchaser obligation has no fair market value. This approach is known as keeping the transaction open, and the effect is identical to applying the cash method of accounting to the transaction. Whoever has the burden of proving either absence or existence of a fair market value usually loses, as the Service discovered when the Tax Court held that its proof of a minimum value was insufficient to show fair market value.⁷⁶ However, courts have found no ascertainable fair market value when the taxpayer introduced uncontradicted evidence of an unsuccessful attempt to market the obligations, together with expert testimony that the obligations were without fair market value.⁷⁷ Still other cases have required ready marketability before finding a fair market value,⁷⁸ although this requirement is without support in the legislative history.⁷⁹ Moreover, at least one case found that a contract had no ascertainable fair market value notwithstanding that it was a type passed from hand to hand in commerce.⁸⁰

Two recent cases in the Tax Court may indicate that the open-

gain from a sale or exchange applies. *Turner v. Commissioner*, 20 T.C.M. (CCH) 468 (1961), *rev'd in part on other grounds*, 303 F.2d 94 (4th Cir.), *cert. denied*, 371 U.S. 922 (1962), involved transfer of a sole proprietorship to a controlled corporation in a transaction qualifying for nonrecognition of gain under section 351. The taxpayer had valued his proprietorship with an exorbitant amount of goodwill, thereby unnecessarily increasing the amount of gain realized from the transfer. Of course, under section 351 the gain would not have been recognized and no harm would have been done had the taxpayer not also taken a \$49,000, unsecured, non-interest-bearing, short-term "Notice of Indebtedness" from the corporation in addition to his stock. The court held that this note was boot under section 351 and therefore taxable in the year of the exchange. 20 T.C.M. at 746. No consideration whatsoever was given to the possibility that, assuming the taxpayer was on the cash method, the obligation of the corporation might not have been a cash equivalent.

75. See note 74 *supra*. These lines of authority are cited and discussed in notes 76-95 & 111-35 *infra* and accompanying text.

76. *MacDonald v. Commissioner*, 55 T.C. 840, 860-61 (1971), *acq.* 1973-2 C.B. 2. The Service had the burden of proof in *MacDonald* because it was seeking an increased deficiency. Normally the taxpayer carries the burden of proof. See note 189 *infra*.

77. *Miller v. United States*, 235 F.2d 553, 555-56 (6th Cir. 1956); *Cambria Dev. Co. v. Commissioner*, 34 B.T.A. 1155, 1158 (1936), *acq. on this issue* 1937-1 C.B. 4. The courts in *Miller* and *Cambria Development* held that substantial collections in later years were insufficient to show ascertainable fair market value in the year of sale. 235 F.2d at 556; 34 B.T.A. at 1158.

78. *Sterling v. Ham*, 3 F. Supp. 386, 388 (S.D. Me. 1933); *cf. McIntosh v. Commissioner*, 26 T.C.M. (CCH) 1164, 1179-80 (1967) (alternative rationale).

79. See text accompanying notes 32-34 *supra*.

80. *Estate of Ennis v. Commissioner*, 23 T.C. 799, 802 (1955), *nonacq.* 1956-1 C.B. 6.

transaction approach based on nonascertainability is about to enter a period of increased respectability. In *McShain v. Commissioner*,⁸¹ the court held that a \$3,000,000 nonrecourse note secured by a second mortgage on a leasehold interest in a hotel lacked an ascertainable value. The court recognized that expert testimony that the note actually had zero value, based on such factors as the degree of occupancy of the hotel, cash flow from the property, and absence of personal liability—was more relevant to the level of value than to its ascertainability. Nevertheless, the court strained to point out that the testimony was consistent with the latter issue as well.⁸²

The *McShain* court apparently took this approach because the Ninth Circuit had rejected the Tax Court's cash-equivalence analysis in *Warren Jones Co. v. Commissioner*.⁸³ Although cash equivalence is an accounting-method concept and is therefore logically relevant only if the taxpayer's method of accounting governs taxation of the transaction, the result under that approach for cash-method taxpayers like *McShain* is the same as the result under the no-ascertainable-value approach under section 1001.⁸⁴ The *McShain* holding may therefore indicate that the Tax Court, at least, is determined to achieve that result by one means or another. Although cash-equivalence analysis is foreclosed, at least in the Ninth Circuit, the no-ascertainable-value approach may still be available.

An even more interesting case is *Estate of Wiggins v. Commissioner*,⁸⁵ in which the taxpayer had acquired and subdivided a parcel of real property into 1,200 lots. He began selling by contract to individual purchasers.⁸⁶ The contracts were admittedly of dubious value. They required only 5% down and permitted the seller to retain all sums paid as liquidated damages in the event of default. They gave the purchasers the right to trade the lot purchased for any other unsold lot in the tract of equal or higher value, and they promised a 5% credit for any new customers that the purchaser referred to the seller. The taxpayer made no credit checks of his purchasers, nor did he seek to determine whether they had correctly identified themselves. Finally, the seller made no effort to enforce the contracts upon default other than to

81. 71 T.C. 998, 1009 (1979).

82. *Id.* at 1005 & n.2.

83. 60 T.C. 663 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975). In *McShain* the Tax Court expressly noted that it was adopting a new rationale. 71 T.C. at 1005.

84. The cash-equivalence approach is discussed in text accompanying notes 108-32 *infra*.

85. 72 T.C. 701 (1979).

86. The facts of this case form the basis for the hypothetical situation of taxpayer *C* in the introductory example. See text accompanying notes 4-11 *supra*.

repossess the property and try to sell it to someone else.⁸⁷

The Tax Court, relying in part on *McShain*, again concluded that the contracts each had some value, but that none was ascertainable.⁸⁸ The exact basis for the decision is unclear, although the opinion implies that the taxpayer's unwillingness to sell the contracts in blocks at a substantial discount from face—apparently the only way they could be marketed—negated the existence of a willing seller and buyer fundamental to the concept of fair market value. This rationale, however, cannot withstand analysis, because it implies that even an exchange-traded corporate bond may lack ascertainable value if the recipient is unwilling to sell at the market price and instead holds it until maturity or at least until prices rise. In any event, without citing any authority, the court simply stated that determination of market value with “fair certainty” was not possible and therefore held for the taxpayer.⁸⁹

The interesting aspect of *Wiggins* is not its holding on ascertainability; it is only a single case in one of the many differing lines of judicial authority. It will take more than a few Tax Court decisions to establish uniformity among these lines.⁹⁰ The interesting point is that neither the parties nor the court in *Wiggins* even considered the possibility that anything other than section 1001 governed taxation of this particular taxpayer's transactions. A hint of the court's real problem, however, may lie in a footnote to its “fair certainty” standard on ascertainability, in which the court indicated that its conclusion was bolstered by the “accounting morass” that would have resulted had it found an ascertainable value for the contracts.⁹¹ As indicated in the discussion of taxpayer C's position in the introductory example,⁹² one might understandably seek to avoid the individual valuation of 1,200 contracts of this type. Because this taxpayer had established himself in

87. 72 T.C. at 705-06.

88. As in *McShain*, the *Wiggins* court did not clarify how the factors it considered were relevant to the ascertainability issue rather than simply to level of value.

89. 72 T.C. at 713-14.

90. In *Diab v. Commissioner*, [1979] TAX CT. MEM. DEC. (P-H) ¶ 79,475, at 1860, for example, the Tax Court declined to follow *Wiggins*. In *Diab* a taxpayer in the business of buying and selling real estate under contracts not obviously more substantial than those in *Wiggins* failed to carry his burden of proving that the contracts were without ascertainable value. *Id.* at 1865. The “accounting morass” feared by the *Wiggins* panel was avoided because the taxpayer also failed to present any evidence that the fair market value of the contracts was less than face. As a result, the *Diab* court simply accepted the Service's decision to deny any discount. *Id.* at 1867. In effect, the ruling placed the taxpayer on the accrual method, which of course may well be the appropriate method of accounting if other methods do not clearly reflect income. Because the rationale of the decision is based on section 1001, however, rather than on the adequacy of the taxpayer's accounting method, it adds to the confusion surrounding the nonascertainability-of-value approach.

91. 72 T.C. at 714 n.11.

92. See text accompanying notes 4-11 *supra*.

the business of selling lots, however, the same result would have been achieved by starting with the assumption that his method of accounting, rather than section 1001, would determine the amount of income from these transactions. At least in this case, such an approach would have avoided entirely the difficult ascertainability issue.

Thus, the real problem in *Wiggins* may not have been ascertainability, because the accounting morass would have been present even if each purchaser had given a secured negotiable promissory note. The value of such notes might often be substantially less than face, but it seems that the court could make a reasonable estimate of the value of at least some of them. The real problem is that the value will vary with the financial circumstances and reputation of the purchaser, so that the accounting will be intricate notwithstanding the ascertainability of the notes' value.

The confusion surrounding ascertainability is entirely unsatisfactory. First, the absence of standards for determining ascertainability can leave two similarly situated taxpayers in dramatically different tax positions. If a court concludes that the obligation received does not have an ascertainable value, the taxpayer reaps a bonanza: no immediate taxation and capital gain treatment for payments as they are made. If the court, however, happens to find that the value is ascertainable, the taxpayer is faced with a dilemma: if the ascertained value is low, the immediate tax impact is minimized but later payments will often be treated as ordinary income when received; if the ascertained value is high, on the other hand, the immediate tax impact is drastic and later payments may still be treated as ordinary income when received.⁹³ In addition, the very circumstances that might call for special treatment because the obligation received has no ascertainable value usually render the transaction ineligible for the tax relief of the installment sale provisions.⁹⁴ This enhances the possibility of unequal treatment by making everything turn on the ascertainability issue.

Finally, there are other circumstances, usually involving contingent-price contracts, in which the courts might legitimately seek to

93. See, e.g., M. CHIRELSTEIN, *supra* note 60, at 302-03. This problem is discussed in detail in Part V of this Article. See notes 150-92 *infra* and accompanying text.

94. Under current law, a contingency in the purchase price will render the installment sale provisions unavailable because the percentage of gain on each payment cannot be calculated in accordance with the statutory formula. *In re Steen*, 509 F.2d 1398, 1402 n.2 (9th Cir. 1975) (quoting *Gralapp v. United States*, 458 F.2d 1158, 1160 (10th Cir. 1972)). See text accompanying note 249 *infra*. Uncertainty in amount, however, has been central to the taxpayer's argument in a number of cases that have found a contract to have no ascertainable fair market value. *E.g.*, *Burnet v. Logan*, 283 U.S. 404 (1931); *MacDonald v. Commissioner*, 55 T.C. 840, 860-62 (1971), *acq.* 1973-2 C.B. 2; *Dorsey v. Commissioner*, 49 T.C. 606, 629-30 (1968).

avoid the direct application of section 1001's fair market value standard even to isolated transactions and even when a fair market value is in fact ascertainable. In these cases as well, ascertainability is simply not a standard that achieves uniform and equitable results.⁹⁵ Therefore, although there may be cases of true nonascertainability in which open-transaction treatment is appropriate, different rationales are needed in these other circumstances. The basic rationale suggested in this Article, distinguishing between isolated sales and sales in the regular course of business, solves the *Wiggins* problem. The problem of contingent-price contracts is considered in Part VI below.⁹⁶

It is worth noting that *Burnet v. Logan*⁹⁷ does not logically provide a rationale for keeping the transaction open when the fair market value of a purchaser obligation is not ascertainable. The sale in *Logan* took place in March 1916, when the 1913 statute⁹⁸ was in effect. That statute envisioned only the cash method of accounting and contained no special recognition provision covering sales or exchanges.⁹⁹ Consequently, the Court was free to fashion its own measure of gain. Moreover, the accounting method should have governed the timing issue because there was no equivalent of section 1001 to override the accounting provisions of the Act. The substantial legislative revisions and additions that took place from 1916 to 1926,¹⁰⁰ including the special provision for taxing capital gains,¹⁰¹ should have induced a complete reevaluation of the *Logan* approach. The failure of any court to do so, notwithstanding the existence of ample statutory grounds, is undoubtedly a major source of the current confusion.

3. *Accounting-Provision Approach.* A third group of cases relies on the taxpayer's method of accounting to tax gain from the sale of property. Although these cases do not expressly deny the potential applicability of section 1001, few indicate their bases for ignoring it. Those that make an attempt to explain their approach, moreover, usually adopt a line of reasoning that, followed to its logical conclusion, would read section 1001 out of the Code, at least when purchaser obligations are received upon the sale of property. Because separate lines

95. See text accompanying notes 224-58 *infra*.

96. See notes 224-58 *infra* and accompanying text.

97. 283 U.S. 404 (1931).

98. Ch. 16, § 2, 38 Stat. 166 (1913).

99. See note 14 *supra*.

100. See notes 15-39 *supra* and accompanying text.

101. *Cf.* *Dorsey v. Commissioner*, 49 T.C. 606, 635 (1968) (Simpson, J., dissenting) (*Logan* not applicable; value should be ascertained). The first capital gains tax was adopted as part of the Revenue Act of 1921, ch. 136, § 206, 42 Stat. 232.

of authority have developed for accrual-method and cash-method taxpayers, it is perhaps easiest to consider the two types of accounting systems separately.

(a) *Accrual-method taxpayers.* Accrual-method taxpayers in a regular business of building and selling real property have generally been required to include in income the full face amount of the purchaser's obligations. The courts reach this result even when the security for the obligations is plainly insufficient¹⁰² or when the seller is required to deposit funds with the third-party financier as additional security.¹⁰³ If section 1001 is discussed at all, it is held inapplicable on the fictional ground that the purchaser obligation is money rather than property¹⁰⁴ for accrual-method taxpayers. The results of these cases are consistent with the approach suggested in this Article, but the courts have failed to recognize the most obvious justification for section 1001's inapplicability: the taxpayer's method of accounting governs sales in the regular course of business.

Cases involving isolated transactions, on the other hand, take a slightly different tack, passing over section 1001 as applicable only to cash-method taxpayers.¹⁰⁵ Nearly every case involving an isolated sale

102. *First Sav. & Loan Ass'n v. Commissioner*, 40 T.C. 474, 487 (1963). The value of the purchaser obligation plus the downpayment in this case was less than the seller's basis, so the seller sought to be taxed under section 1001.

103. *Western Oaks Bldg. Corp. v. Commissioner*, 49 T.C. 365, 370-74 (1968), *nonacq.* 1968-2 C.B. 3; *Key Homes, Inc. v. Commissioner*, 30 T.C. 109, 111-12 (1958), *aff'd per curiam*, 271 F.2d 280 (6th Cir. 1959). The *Western Oaks* case is interesting because it also involved several sellers who were on the cash method. Although the court acknowledged section 1001, it concluded that a cash-method taxpayer did not have to include a purchaser obligation in income unless it was a cash equivalent, even when for other purposes it might be considered to have a fair market value. 49 T.C. at 376. Consequently, the court actually followed the accounting methods of both types of taxpayers. In terms of the interpretation of section 1001 suggested by this Article, *both* results in *Western Oaks* are correct—a rather extraordinary case, since so few others have managed to reach even *one* correct result. The rationale under the suggested approach would, of course, be different from the court's in *Western Oaks*; the analysis in this Article would emphasize that the taxpayers involved were all in the business of selling the property on a regular basis. *Id.* at 367.

104. *First Sav. & Loan Ass'n v. Commissioner*, 40 T.C. 474, 487 (1963).

105. *Freitas v. Commissioner*, 25 T.C.M. (CCH) 545, 555 (1966) (sale of stock); *George L. Castner Co. v. Commissioner*, 30 T.C. 1061, 1067-68 (1958) (sale by an accrual-method business of all of its assets); *Brown v. Commissioner*, 9 T.C.M. (CCH) 1054, 1060 (1950) (sale of partnership interest). The taxpayer in *Brown* apparently was engaged in a number of businesses involving vending machines and similar food distribution operations, but the opinion is not clear whether the taxpayer was in the business of selling these business interests. In any event, that certainly was not the ground for the decision.

Another confusing twist in this area centers around Treas. Reg. § 1.453-6 (1958) and its predecessors, which provide that in sales of real property not eligible for the installment method of reporting, gain or loss is to be measured by the fair market value of the purchaser obligation received. Both *Freitas* and *Castner* held that this regulation does not apply to casual sales of personal property by accrual-method taxpayers. Neither court, however, seemed to notice that the

by an accrual-method taxpayer follows this rationale. The Service has also consistently taken the view that the taxpayer's method of accounting governs taxation of sales by accrual-method taxpayers, whether the sales are isolated or in the course of a business.¹⁰⁶ Thus, section 1001 has essentially been read out of the Code for accrual-method taxpayers.¹⁰⁷ Unfortunately, it is not clear why section 1001 should apply to cash-method taxpayers but not to accrual-method taxpayers.

(b) *Cash-method taxpayers.* The preponderance of reported sale-of-property cases have involved cash-method taxpayers, and these cases are far less uniform in rationale and result. As already noted,¹⁰⁸ some courts apply a literal reading of section 1001 to cash-method taxpayers, and others have taken a doctrinally related open-transaction approach based on nonascertainability of value.¹⁰⁹ Still others apply what might be termed a "mixed" approach (mixing section 1001 and the accounting provisions).¹¹⁰ Another line of cases, however, has relied solely on the taxpayer's method of accounting, essentially excluding analysis under section 1001.

The statement of the rule most often quoted in these cases comes from *Johnston v. Commissioner*,¹¹¹ which involved a sale of stock in 1942 under a contractual arrangement requiring that a downpayment be paid into escrow in that year and that a contingent balance be paid in 1943 when the exact price could be determined. In a reversal of the usual roles, the taxpayer sought to recognize his gain in 1942 but the Service determined that the gain was taxable in 1943. Although the

regulation is indistinguishable from section 1001. Moreover, the *Western Oaks* court, 49 T.C. 365, 372 n.4 (1968), *nonacq.* 1968-2 C.B. 3, concluded that this regulation did not apply even to sales of real property by accrual-method taxpayers. For a discussion of the history of this regulation, see Haley, *supra* note 34, at 319-21.

106. Rev. Rul. 79-292, 1979-39 I.R.B. 18. See note 71 *supra*. In another recent ruling the Service held that a 1977 securities litigation settlement in which the defendant promised to pay the accrual-method taxpayer a fixed sum was taxable in 1977 in the full face amount promised. Rev. Rul. 79-278, 1979-37 I.R.B. 18. This amount was actually paid in 1978. Because it appears that an isolated transaction was involved, the approach suggested in this Article would find gain only to the extent of the fair market value of the promise received in 1977.

107. In *Rubino v. Commissioner*, 8 T.C.M. (CCH) 1095 (1949), *aff'd per curiam on another issue*, 186 F.2d 304 (9th Cir. 1951), an accrual-method taxpayer was apparently taxed under the literal section 1001 approach. The opinion contains essentially no discussion of the relevance of the taxpayer's method of accounting. However, the obligations in question were valued by the Service at face value, and the taxpayer failed to meet his burden of proving this determination wrong. Therefore, the result is the same as obtained by ignoring section 1001 and relying on the taxpayer's accrual method. See note 90 *supra*.

108. See text accompanying notes 73-75 *supra*.

109. See text accompanying notes 76-101 *supra*.

110. See text accompanying notes 133-44 *infra*.

111. 14 T.C. 560 (1950).

court recognized the possibility of applying *Burnet v. Logan*¹¹² to these facts,¹¹³ it did not decide the case on this basis. Rather, the court focused on the distinction between cash- and accrual-method taxpayers: for a taxpayer on the cash method, the issue is whether the obligation received on a sale of property is a cash equivalent. Moreover, a contractual obligation is not a cash equivalent if it "inerely require[s] future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce . . . [are] given or accepted . . ."¹¹⁴ This, of course, is a valid statement of cash equivalence in cases not involving the disposition of property, in which no special timing provisions apply.¹¹⁵ Applied to property sales, however, this definition has the effect of reading section 1001 out of the Code.¹¹⁶ Section 1001 says nothing about cash equivalence, a concept designed to prevent abuses by cash-method taxpayers through manipulation of their accounting method. To apply the cash-equivalence test to sales transactions is to say that the taxpayer's method of accounting always prevails. Nevertheless, a large number of cases have relied on this statement from *Johnston* to apply cash-equivalence concepts to the taxation of the sale or exchange of property.¹¹⁷

Because the *Johnston* opinion is so often cited, it is worth examining its erroneous foundation in some detail. The *Johnston* court not only failed to consider the statutory provisions governing the transaction with which it was dealing; it also relied on several prior decisions that either were inapplicable because of changes in the relevant statutes

112. 283 U.S. 404 (1931).

113. 14 T.C. at 565, 566. Covering all bases, the court also noted that the record failed to establish a fair market value for the contract in 1942. *Id.* at 566. Nevertheless, most of the opinion centers on the cash-equivalence analysis.

114. *Id.* at 565.

115. *E.g.*, *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961) (involving notes received as partial payments on a lease). See notes 62-69 *supra* and accompanying text.

116. The *Johnston* court expressly rejected, as contrary to his cash accounting method, the taxpayer's attempt to apply the predecessor of section 1001 to the contract. 14 T.C. at 565.

117. *Silverton v. Commissioner*, 36 T.C.M. (CCH) 817, 833 (1977); *Lowe v. Commissioner*, 33 T.C.M. (CCH) 652, 653 (1974); *Warren Jones Co. v. Commissioner*, 60 T.C. 663, 669 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975); *Western Oaks Bldg. Corp. v. Commissioner*, 49 T.C. 365, 376-77 (1968), *nonacq.* 1968-2 C.B. 3; *Estate of Hurlburt v. Commissioner*, 25 T.C. 1286, 1288 (1956), *nonacq.* 1956-2 C.B. 10; *Ennis v. Commissioner*, 17 T.C. 465, 470 (1951); *cf.* *McIntosh v. Commissioner*, 26 T.C.M. (CCH) 1164, 1179 (1967) (while negotiable promissory notes given in exchange for property are property within meaning of term in section 1001(b), nonnegotiable, non-interest-bearing notes are not); *Andrews v. Commissioner*, 23 T.C. 1026, 1035 (1955) (mere promise of future payments in contract of sale is not "property" as intended in predecessor of section 1001). Many of these cases achieved results favorable to the taxpayer, and there is perhaps a degree of frontier justice in hanging the Service with the rope it helped fashion in *Johnston*. However, the inconsistency and confusion the case has caused is a heavy price.

or were wrongly decided. One example is *Bedell v. Commissioner*,¹¹⁸ in which Judge Learned Hand delivered his familiar admonition that "it is absurd to speak of a promise to pay a sum in the future as having a 'market value,' fair or unfair."¹¹⁹ The transaction in *Bedell*, however, was governed by the Revenue Act of 1918.¹²⁰ Thus, the *Bedell* court had no need to analyze the implications of the legislative developments in 1921, 1924, and 1926, all of which suggest that a promise of future payment should, under the current statutory scheme, be included in the measure of income at its fair market value.¹²¹ Accordingly, even those who agree with Hand's conclusion that it is absurd to attribute a market value to promises of future payment must come to grips with the opposite conclusion subsequently drawn by Congress. Moreover, although it was not part of the *Bedell* analysis, there is a respectable argument that because the specific statutory recognition provision covered only *exchanges*, the accounting provisions governed the timing of taxation of all *sales* transactions under the 1918 statute.¹²² If this argument is valid, cash-equivalence analysis correctly achieves Hand's result.

The *Johnston* court also relied on *Ruprecht v. Commissioner*,¹²³ in which a cash-method taxpayer received in exchange for real property the purchaser's promise to pay \$10,000 per year for five years. The *Ruprecht* court held that the taxpayer did not have to include the value of this promise in his income for the year of sale,¹²⁴ emphasizing that the only written evidence of the purchaser's promise was contained in the deed to the property and that the seller received no other written contract or note.¹²⁵ The court¹²⁶ made no reference to the applicable

118. 30 F.2d 622 (2d Cir. 1929) (alternative holding).

119. *Id.* at 624. The *Bedell* case is another in which the normal roles of the taxpayer and the Service were reversed. See text accompanying notes 99-101 *supra*. The taxpayer contracted to sell real property in 1919 and argued that the sale took place in that year rather than in 1920 when the closing occurred and title passed. The court concluded that the taxpayer realized gain only when the sale was completed in 1920, 30 F.2d at 624, and therefore the discussion of cash equivalence in the opinion may properly be regarded as dictum. Nevertheless, the quoted language has been very influential.

120. Ch. 18, § 202(b), 40 Stat. 1057 (1919).

121. See text accompanying notes 21-39 *supra*. The *Bedell* court did note that the statutory provisions had been liberalized in 1921 in favor of the taxpayer, but it concluded that this did not imply a stricter approach under the 1918 statute that governed the case. 30 F.2d at 624. The court made no attempt to interpret the retrenchment in 1924 or the adoption of the installment sale provisions in 1926.

122. See notes 18-20 *supra* and accompanying text.

123. 16 B.T.A. 919, 921-22, *acq.* VIII-2 C.B. 46 (1929), *aff'd on another issue*, 39 F.2d 458 (5th Cir. 1930).

124. 16 B.T.A. at 922.

125. That the purchaser involved happened to be the Standard Oil Company apparently did not move the *Ruprecht* panel.

126. For simplicity, this Article refers to the Board of Tax Appeals, the forerunner of today's

statute,¹²⁷ and its reliance entirely on cash-equivalence analysis indicates that the court considered only the accounting provisions relevant. Nonetheless, the sale in *Ruprecht* took place in 1921 and was subject to the liberal provisions of the Revenue Act of 1921.¹²⁸ Consequently, the result in *Ruprecht* can easily be justified under the then-applicable statutory law. In addition, regardless of how one interprets the exchange provisions under the 1918 and 1921 Acts, neither *Ruprecht* nor *Bedell* can logically serve as authority for transactions occurring after 1926; between 1918 and 1926 Congress had addressed the problem of taxing dispositions of property no fewer than three times.¹²⁹

The major error in the development of judicial authority in this area occurred in *Humphrey v. Commissioner*,¹³⁰ in which a cash-method taxpayer successfully argued that nonnegotiable notes he received upon the sale of his interest in a partnership were not cash equivalents and therefore not taxable until actually paid. The Board of Tax Appeals relied heavily on *Bedell*, particularly on the language quoted above,¹³¹ without recognizing that intervening legislative developments required a new look at the *Bedell* analysis. The *Johnston* case not only followed *Humphrey* and *Bedell*, but it compounded those errors with similarly mistaken reliance on *Ruprecht*.¹³² Consequently, the cases following *Johnston* and *Humphrey*, relying solely on cash-equivalence analysis to resolve the timing question for dispositions of property, are based on a major, but apparently unintentional, oversight by the Tax Court.

4. *Mixed Approaches.* (a) *No "property" received.* Other cases have acknowledged the potential applicability of section 1001 or its predecessors to dispositions of property. In dealing with section 1001, however, these courts have reasoned that a contractual obligation of the purchaser not evidenced by a negotiable and freely transferable note or other evidence of indebtedness is not property to a cash-method

Tax Court, as a "court," although until recently it may more properly have been regarded as an independent agency of the executive branch. See, e.g., B. BITTKER & L. STONE, FEDERAL INCOME ESTATE & GIFT TAXATION 941 (1972).

127. Revenue Act of 1921, ch. 136, 42 Stat. 227.

128. The sale in *Ruprecht* took place in June 1921 and the Revenue Act of 1921 was not adopted until November of that same year. Ch. 136, 42 Stat. 227. However, the 1921 statute covered fiscal years ending during calendar year 1921 as well as fiscal years ending December 31, 1921. *Id.* § 200(1).

129. See notes 21-39 *supra* and accompanying text.

130. 32 B.T.A. 280, 282, *nonacq.* XIV-2 C.B. 34 (1935).

131. 32 B.T.A. at 282.

132. 14 T.C. at 566.

taxpayer and therefore is not includable in the amount realized under section 1001.¹³³ Thus, the outcome is the same as in *Johnston* and *Humphrey*: no immediate taxation to a cash-method taxpayer unless he receives a true cash equivalent.¹³⁴ The result under this approach is exactly the same as looking solely to the accounting provisions and altogether ignoring section 1001, the provision specifically designed to cover the question.¹³⁵

(b) *Expanded cash-equivalence approach.* A second group of cases has been less willing to read section 1001 out of the Code in principle or in practice, but these courts are also unable to ignore the accounting provisions. They begin by finding, through one method or another, that the purchaser obligation in question has a fair market value and that taxation under section 1001 is appropriate. They then resolve the apparent conflict between section 1001 and the accounting provisions by expanding the concept of cash equivalence in connection with the sale of property, so that the purchaser obligation received by the seller is *defined*, often implicitly, to be a cash equivalent to the extent of its fair market value. As a cash equivalent, the obligation is treated identically under section 1001 and the cash method of accounting.

One decision, for example, found that the obligations involved had a fair market value and then concluded that they were cash equivalents. The court based this conclusion solely on the notes' negotiability, even though the obligor was a thinly capitalized corporation and the notes had a value much less than face.¹³⁶ Admittedly, the pres-

133. *McIntosh v. Commissioner*, 26 T.C.M. (CCH) 1164, 1179-80 (1967); *Andrews v. Commissioner*, 23 T.C. 1026, 1035 (1955); *Kleberg v. Commissioner*, 43 B.T.A. 277, 289 (1941), *acq. withdrawn* 1952-1 C.B. 5; *cf. Warren Jones Co. v. Commissioner*, 60 T.C. 663, 670 (1973) (Scott, J., concurring) (question in case was factual one of whether contract was "property received" such that the fair market value of the property was part of the amount realized by the petitioner from the sale of the apartment building under section 1001(b)), *rev'd*, 524 F.2d 788 (9th Cir. 1975).

134. The phrase "true cash equivalent" is used here to mean an item that would be considered income to a cash-method taxpayer even if it were received independent of a disposition of property—for example, as compensation for services or as a dividend. Thus, the term "true cash equivalent" refers to the narrow test of cash equivalence, as opposed to the somewhat broader test that has been developed by a few courts in the sale-and-exchange area. See notes 62-69 *supra* and 136-44 *infra* and accompanying text.

135. This approach is similar to treating a purchaser obligation as money to an accrual-method taxpayer. See notes 104-05 *supra* and accompanying text. In both situations an intangible that has value to the taxpayer and can be freely encumbered is treated as something other than property in calculating the amount realized under section 1001.

136. *Marcello v. Commissioner*, 43 T.C. 168, 180-81 (1964), *remanded on other grounds*, 380 F.2d 494 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968). A recent Tax Court decision also read the *Johnston* rule literally and held that a \$25,000 note received in connection with the sale of a law practice was a cash equivalent. *Silverton v. Commissioner*, 36 T.C.M. (CCH) 817, 823 (1977). The court did not discuss whether the note was negotiable in form. The court also found that a

ence of a negotiable promissory note does distinguish the result here from the cases that have relied solely on cash-equivalence analysis. The latter have involved purely contractual obligations, as in *Johnston*, or at most a nonnegotiable instrument, as in *Humphrey*. This distinction, however, lacks economic substance because it looks solely to the form of the obligation and ignores factors that may affect its acceptance in the marketplace. Courts considering cash-equivalence concepts outside the disposition-of-property area have long realized that to define all promissory notes as the equivalent of cash is nothing more than a legal fiction.¹³⁷ In fact, several courts contributing to this line of cases have concluded that even a purely contractual obligation taken in connection with the sale of property can be a cash equivalent if there is a market for the particular type of contract.¹³⁸

The cases in this line, because they rely essentially on section 1001, come to the same result as the approach advocated in this Article, at least to the extent they have involved only isolated transactions. In failing to recognize, however, that the accounting provisions should not apply to isolated sales, these courts have unnecessarily felt compelled to deal with the concept of cash equivalence. If that concept were relevant, a test requiring marketability and the actual existence of a market would have considerable appeal. Formal distinctions such as negotiability, which as a practical matter may be irrelevant to whether any cash can actually be realized, would enter the analysis, if at all, only as factors affecting value. The valuation problem itself is also more easily and more accurately resolved when there is a ready market for obligations of the particular type.¹³⁹ Nevertheless, before embarking on a cash-equivalence analysis, one should ask the reason for considering the concept at all. Cash equivalence is an accounting-provision concept designed to prevent evasive delaying tactics by cash-method taxpayers when timing is properly governed by the taxpayer's method of accounting.¹⁴⁰ The definition of any analytical term should, at least

contractual obligation not evidenced by a note but received in the same transaction was not a cash equivalent. The note, but not the contractual obligation, was therefore includable as an amount realized in the income of the cash-method taxpayer. *Id.* at 833.

137. *E.g.*, *Cowdeu v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961). See notes 62-69 *supra* and accompanying text.

138. *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 790 & n.4 (9th Cir. 1975); *Heller Trust v. Commissioner*, 382 F.2d 675, 681 (9th Cir. 1967); *Kaufman v. Commissioner*, 372 F.2d 789, 793-94 (4th Cir. 1966); *Perelman v. Commissioner*, 41 T.C. 234, 242 (1963), *acq.* 1965-2 C.B. 6. All these cases involved real estate sales contracts on a standard form for which there was at least a local market.

139. See *Denver & R.G.W.R.R. v. United States*, 318 F.2d 922, 928 (Ct. Cl. 1963). See also text accompanying notes 167-74 *infra*.

140. See note 68 *supra* and accompanying text.

ideally, be the same for all matters to which it properly applies, and to broaden the concept of cash equivalence in the special case of property dispositions can only add confusion in areas in which the concept is more appropriately narrow, such as compensation for services.¹⁴¹ Such broadening under this line of cases is totally unnecessary, because the cases assume that the express timing statute, section 1001, applies. If these courts only realized that this assumption logically precludes application of the accounting provisions, the apparent conflict would disappear and no distortion of language would be necessary to resolve it. Because section 1001 does not refer to cash equivalence, there is no reason to consider the concept at all.

Moreover, to broaden the concept of cash equivalence for cash-method taxpayers leaves open the correct treatment of accrual-method taxpayers. Either of the two possible approaches has its problems. On the one hand, it is possible to treat purchaser obligations as money to accrual-method taxpayers, but to treat identical obligations as property to cash-method taxpayers only to the extent that the obligations are cash equivalents under the broad definition of that term. The problem with this approach has already been discussed above:¹⁴² it ignores the timing implications of section 1001 in favor of the taxpayer's method of accounting. On the other hand, to treat the obligations similarly for both types of taxpayers implies that section 1001 is the governing provision, but that section literally speaks about fair market value and not about cash equivalence. Consequently, the relevant inquiry is to the factors that properly go into the determination of fair market value. Although the existence of a market and a high degree of marketability may be crucial to a rational definition of cash equivalence, neither of these factors is determinative of the existence (as opposed to the de-

141. See text accompanying notes 62-69 *supra*. The confusion also runs in the reverse direction. For example, a frequently cited cash-equivalence case is *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), which involved bonus payments in connection with an oil lease. The bonus took the form of a contractual obligation to pay money in the future. After rejecting formalistic tests like negotiability, the court defined a cash equivalent to be "a promise to pay of a solvent obligor [that] is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money." *Id.* at 24.

The limitation on the degree of discount is an important restriction in the *Cowden* definition and is probably appropriate outside the property disposition area. See notes 62-69 *supra* and accompanying text. However, the Ninth Circuit in *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), felt compelled to distinguish *Cowden* in a sale-of-property setting by saying that the discount language in *Cowden* was only descriptive of the obligation involved in that case and not a general requirement for cash equivalence. *Id.* at 794 n.9. The court in *Warren Jones* would not have had so much trouble if it had recognized that cash equivalence is irrelevant to transactions governed by section 1001.

142. See text accompanying notes 102-07 & 133-35 *supra*.

gree) of fair market value.¹⁴³ In addition, to import a cash-equivalence standard into section 1001 contradicts the evident intent of Congress when it eliminated the requirement in the Revenue Act of 1921 of a readily realizable market value as a condition to immediate taxation.¹⁴⁴ Consequently, before discussing the concept of cash equivalence, one should first decide whether the taxpayer's accounting method or section 1001 governs taxation of the transaction. If section 1001 governs, the search for cash equivalence should be abandoned and attention focused on the factors that determine the fair market value of the property received.

C. *Summary.*

In considering whether the taxpayer's accounting method or section 1001 should govern the timing issue, it is helpful to summarize the various judicial approaches and their deficiencies.

Cases that resort to section 1001 without considering the taxpayer's accounting method ignore the usefulness of reliance on the taxpayer's method of accounting when property sales are part of a regular ongoing business. This approach unnecessarily requires a cumbersome and inaccurate valuation mechanism, because by hypothesis the taxpayer's method of accounting does not distort his income.¹⁴⁵

The cases finding that a particular obligation had no ascertainable fair market value are not clearly objectionable in the abstract, but one must question whether there are many obligations whose value is in fact nonascertainable. Moreover, so many methods of valuation have been developed¹⁴⁶ that it is impossible to identify clear standards to determine whether a fair market value is or is not ascertainable. Consequently, most cases are result-oriented and without predictive value. This approach can leave two similarly situated taxpayers in very different tax positions. Especially when installment reporting is unavailable, similarly situated taxpayers may find themselves facing diametrically opposite tax results, because all tax consequences will turn on the ascertainability issue. Finally, and possibly most important, as-

143. It will not do to object that a fair *market* value test implies a requirement that a market exist, because a market is rarely even considered as a condition of immediate taxation when the seller receives third-party obligations or tangible property in the transaction. See note 54 *supra* and accompanying text.

144. See notes 21-39 *supra* and accompanying text.

145. Otherwise, the Service is authorized to recompute income by a method that does accurately reflect income. § 446(b).

146. In *Burnet v. Logan*, 283 U.S. 404 (1931), the Court noted that the very contract whose value could not be ascertained had been valued for estate tax purposes. *Id.* at 413. See also *McShain v. Commissioner*, 71 T.C. 998, 1009 n.4 (1979).

certainability is often not the real problem, and only confusion can arise when this standard is warped to achieve results demanding a different rationale.

The cases that rely solely on the taxpayer's accounting method ignore both the language of section 1001 and the evident intent of Congress that taxation of gain from property dispositions be governed by that section unless the transaction qualifies for the ameliorative installment sale provisions. The rationale of these cases would also unjustly distinguish between cash- and accrual-method taxpayers who make isolated sales of similar property on similar terms outside their regular businesses.

The cases that treat a purchaser obligation as money in the hands of an accrual-method taxpayer and as something other than property in the hands of a cash-method taxpayer purport to rely on section 1001. In fact, these cases deny its application, because the result in each case is determined solely by the taxpayer's method of accounting. Moreover, this approach either explicitly or implicitly assumes the applicability of section 1001, but that section provides no express basis for distinguishing between the two types of taxpayers. Finally, this interpretation of section 1001 gives the same word in the same section of the Code different meanings, and the only justification for the variable definition is the result achieved. The best that can be said in favor of this approach is that it does rationalize some of the cases that have distinguished between cash- and accrual-method taxpayers under section 1001.¹⁴⁷

The cases that use an expanded definition of the accounting-method concept of cash equivalence in property-disposition transactions do so for reasons that have nothing to do with accounting. The courts use this analysis in an attempt to accommodate the apparent command of section 1001. As a result, the concept of cash equivalence is likely to become clouded in matters that are not governed by any special timing provision and that require a narrow definition of the concept.¹⁴⁸ Moreover, these cases do not achieve a rational accommodation of section 1001 to the accounting provisions. To the extent that courts adopting this rationale continue to distinguish between accrual- and cash-method taxpayers, they still rely solely on accounting meth-

147. Haley, *supra* note 34, at 321.

148. If the concept of cash equivalence is to be expanded, the expansion should be related to the goals that cash equivalence and the related doctrine of constructive receipt are intended to serve: the prevention of income distortion through evasive delaying tactics by cash-method taxpayers.

ods rather than on section 1001 to determine the timing of taxation.¹⁴⁹ On the other hand, to the extent that the cases treat both types of taxpayers similarly, they do no more than import an accounting-method concept into section 1001 without any apparent reason for doing so.

V. OPERATION OF THE SUGGESTED APPROACH

A. *General Operation.*

Because no single approach has become well enough established that only congressional reform is possible, it is not too late to offer an interpretation of the current statutes that provides a more coherent rationale and more predictable results.¹⁵⁰ Under the approach suggested by the statutory development, the key distinction would be whether a sale or other disposition takes place in a regular course of a business or is instead a casual or isolated transaction.¹⁵¹ Property dispositions in the ordinary course of business would be governed by the taxpayer's method of accounting for income from that particular business, while transactions outside the ordinary course of business would be subject to section 1001. The timing of taxation in either case would, of course, be overridden by the installment sale provision¹⁵² whenever the taxpayer is eligible for and elects to report gain under section 453.¹⁵³

One obvious advantage of this approach is its consistency with the evident intent of Congress in originally adopting the predecessors of section 1001. At the same time, this interpretation would give both the accounting provisions and section 1001 substantial nonoverlapping operative scope. It would eliminate the need for complex and necessarily inaccurate valuations of obligations received as part of a regular business,¹⁵⁴ and, probably even more important, it would go far toward eliminating litigation over valuations in those cases.¹⁵⁵ It would end

149. These courts use section 1001, however, to modify the cash method in the special case of property dispositions by making it a basis for expanding the cash-equivalence concept.

150. Legislative proposals have been made that, if enacted, would greatly affect many property sales. All these proposals, however, suffer from the basic problem that has infected judicial analysis: the failure to distinguish between regular and isolated sales. The proposals are discussed in text accompanying notes 259-282 *infra*.

151. See text accompanying notes 42-50 *supra*.

152. § 453.

153. There is, of course, a further exception for any transaction governed by a specific timing or nonrecognition provision, such as a tax-free reorganization or an exchange of like-kind property. The analysis in the text applies when the transaction does not fit within one of these special categories.

154. The same approach could also be used in connection with third-party obligations received in the regular course of business, with the same advantage of eliminating the need for valuations. See note 55 *supra*.

155. Of course, in the majority of cases, the sales-business taxpayer's method of accounting

discrimination between otherwise similarly situated cash- and accrual-method taxpayers who sell property unrelated to the businesses for which their accounting systems were adopted.¹⁵⁶ Further, because the approach gives coherent scope to potentially applicable but apparently contradictory statutory provisions, it provides a theoretical framework that should eliminate the confusion resulting from judicial attempts to apply more than one provision to the same problem. Finally, the suggested approach would provide predictability for taxpayers contemplating sale-of-property transactions.¹⁵⁷

The suggested resolution focuses on a number of questions. The

evidently is accepted by the Service without any attempt by either side to apply section 1001. Otherwise, the entire tax bureaucracy would be swamped with valuation proceedings. Nevertheless, in a significant number of cases, all involving taxpayers in the business of improving or otherwise dealing in real estate, either the Service or the taxpayer has sought to apply section 1001. *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967); *Kaufman v. Commissioner*, 372 F.2d 789 (4th Cir. 1966); *Miller v. United States*, 235 F.2d 553 (6th Cir. 1956) (sole transferee of all assets of corporation in real estate business); *Owen v. United States*, 8 F. Supp. 707 (Ct. Cl. 1934); *Diab v. Commissioner*, [1979] TAX CT. MEM. DEC. (P-H) ¶ 79,475, at 1860; *Estate of Wiggins v. Commissioner*, 72 T.C. 61 (1979); *Witte v. Commissioner*, 31 T.C.M. (CCH) 1137 (1972) (stipulation), *rev'd on other grounds*, 513 F.2d 391 (D.C. Cir. 1975); *Perelman v. Commissioner*, 41 T.C. 234 (1963), *acq.* 1965-2 C.B. 6; *Rubino v. Commissioner*, 8 T.C.M. (CCH) 1095 (1949) (applying predecessor of section 1001 to accrual-method taxpayer in regular real estate business but concluding that fair market value of obligation was equal to its face value, thereby reaching same result that taxpayer's accounting method would have provided), *aff'd per curiam on other grounds*, 186 F.2d 304 (9th Cir. 1951); *Cambria Dev. Co. v. Commissioner*, 34 B.T.A. 1155 (1936) (applying section 1001 to taxpayer in regular business but concluding that obligations received had no ascertainable fair market value), *acq. and nonacq.* 1937-1 C.B. 4. Other courts have impliedly or expressly rejected a proposed application of section 1001 to accrual-method taxpayers in a regular real estate business, but none have made the regular business a ground for the decision. *Western Oaks Bldg. Corp. v. Commissioner*, 49 T.C. 365 (1968), *nonacq.* 1968-2 C.B. 3; *First Sav. & Loan Ass'n v. Commissioner*, 40 T.C. 474 (1963); *Key Homes, Inc. v. Commissioner*, 30 T.C. 109 (1958), *aff'd per curiam*, 271 F.2d 280 (6th Cir. 1959).

156. The distinction cuts in two directions. The more frequent situation involves an accrual-method taxpayer who is taxed on the full face amount of the obligation he receives in an isolated transaction. See notes 102-03 *supra* and accompanying text. The other possibility involves a purchaser obligation in which the total amount payable is contingent on future events. Because not all the events necessary to fix the amount of the obligation with reasonable accuracy have occurred, this amount should not be immediately taxable to an accrual-method taxpayer if his accounting method governs timing. See *Treas. Reg. § 1.446-1(c)(ii)* (1957). Nevertheless, the contingency may not be so strong that the obligation cannot be valued, and under an expanded interpretation of cash equivalence a cash-method taxpayer may face immediate taxation in accordance with the fair market value of the obligation. Under the proposed approach, the only question in the case of an isolated transaction is whether the obligation has a fair market value. If it does, the tax result is the same for both taxpayers.

157. Of course, for isolated transactions, there is considerable uncertainty in the determination of fair market value. Nevertheless, this uncertainty is a much narrower issue. Moreover, the taxpayer knows the relevant factors in the analysis, such as solvency of the obligor, amount and type of security, degree of discount, and ease of marketability. He can therefore build a record substantiating his position. In the vast majority of cases, there is likely to be a fair market value above whatever minimum the taxpayer would like not to exceed. In this case the taxpayer knows that he must structure the transaction to make himself eligible for installment reporting.

most obvious issue concerns the standards for determining whether a sale is isolated or in the regular course of a business. Second, if the sale is isolated, it is necessary to determine the section 1001 fair market value of the purchaser obligation received. The rest of Part V analyzes these two issues.

B. *Definition of Isolated Transactions.*

Under the suggested approach, any sales transaction must be characterized either as isolated or as in the regular course of a business. Although there are no judicial definitions of an isolated transaction in the specific context of section 1001, the distinction should not be too difficult in practice. The issue may accurately be rephrased in terms of whether the accounting method used in the taxpayer's regular business or employment could sensibly be applied to the transaction. For example, if the taxpayer maintains an inventory of the item sold, if he has previously reported similar sales using the accounting method of his business or employment, or if he sells a new or unusual item through an established sales operation, the transaction should probably be considered a regular sale. The very purpose of his accounting method is to give uniform and consistent treatment to these transactions. On the other hand, suppose the taxpayer sells his personal residence or all the stock or assets of a wholly owned business. There will normally be no reason to apply to these sales the accounting system he uses in reporting income from ordinary individual transactions in his business or employment. With respect to the isolated sales, the consistency necessary to make sense of an accounting system is lacking.¹⁵⁸

Further guidance is available from section 453. The installment sale provisions expressly distinguish between regular sales of personal property on the installment plan and casual sales of personal property

158. See text accompanying notes 43-45 *supra*. The distinction between regular and isolated transactions could perhaps be made even more predictable with a strict numerical test. For example, the California sales tax applies to retail sales of personal property, but there is an exemption for occasional sales. CAL. REV. & TAX. CODE § 6006.5(a) (West 1970); *id.* §§ 6051, 6367 (West Supp. 1979). The state's Board of Equalization regulations hold that, in general, three sales of similar character render the occasional-sale exemption unavailable. Cal. Bd. of Eq. Regs. § 1595(a) (1972). A strict numerical test, however, may have its own problems. For example, if the taxpayer were free to choose a method of accounting for his "business" whenever the specified number of sales transactions was exceeded, many taxpayers might abuse the system by artificially increasing their number of sales in order to escape section 1001 treatment. On the other hand, if the method of accounting otherwise used by the taxpayer in his unrelated business or employment were to apply automatically whenever the number was exceeded, hardship could result—for example, when an accrual-method taxpayer in his usual business sells stock held as a side investment in several close corporations. Therefore, a strict numerical test is probably inadvisable absent evidence that individualized attention is unmanageable.

for a price exceeding \$1,000.¹⁵⁹ Litigation over this fifty-year-old distinction has been infrequent, so that the distinction does not appear to be a difficult one to make in practice. The authority that does exist supports the examples given in the previous paragraph. Thus, an early general counsel memorandum concluded that the sale of a pearl on unusual terms by a person in the jewelry business is not casual within the meaning of the predecessor of section 453,¹⁶⁰ while courts have held that the sale by a corporation of all of its assets¹⁶¹ and a series of sales of corporate stock holdings by a business executive¹⁶² are casual. This authority under section 453 is directly relevant to the regular/isolated distinction suggested for determining the application of section 1001. Indeed, the proposed approach requires that sections 1001 and 453 be read together, leaving only section 453 to relieve the rigors of section 1001. If a transaction is sufficiently irregular to be covered by section 1001 rather than the taxpayer's method of accounting, it should also qualify as a casual sale under section 453.¹⁶³ The distinction between isolated transactions and regular transactions in the course of business should be handled identically for both section 453 and section 1001 purposes.¹⁶⁴

C. *Valuation of Purchaser Obligations.*

If a transaction is isolated and section 1001 applies, the taxpayer still must determine the fair market value of the purchaser obliga-

159. Section 453 makes this distinction for the purpose of determining when the installment method is available. § 453(a)-(b).

160. G.C.M. 1162, VI-1 C.B. 22, 24 (1927).

161. *McDonald v. Commissioner*, 52 F.2d 920, 922 (4th Cir. 1931).

162. *Greenwood v. Commissioner*, 34 B.T.A. 1209, 1211-12 (1936), *acq.* 1937-1 C.B. 11. The taxpayer in *Greenwood* owned about 200,000 of the outstanding 300,000 shares of an insurance company and hired a broker to sell up to 20,000 of his shares. The broker in turn used as many as 14 salesmen at one time to sell the shares either for cash or for a specified percentage down with the balance to be paid in installments. The sales were nevertheless held to be casual because the taxpayer was not regularly engaged in buying and selling stock and the sales were not connected with his business as an executive. 34 B.T.A. at 1210-12.

Greenwood pushes the definition of "casual" close to the borderline. For a large number of similar sales, especially over several annual accounting periods, the valuation requirement of section 1001 is both cumbersome and unnecessary. A separate accounting method could be adopted for the "business" of selling the stockholdings serially. Nevertheless, the case is still good authority for the proposition that sales of stock unrelated to one's regular employment should not be governed by the method of accounting for income from such employment. The sales either are isolated or constitute a separate business.

163. If a personal property transaction does not qualify as a casual sale under section 453, the installment method of reporting is available only when the taxpayer regularly engages in the sales on the installment plan.

164. Similarly, if a transaction is in the regular course of the taxpayer's business and therefore covered by his accounting method rather than section 1001, the sale should not be casual under section 453. Because the sale is not casual, the only issue with respect to section 453 eligibility should be whether the taxpayer regularly sells on the installment plan. § 453(a)(1).

tion.¹⁶⁵ The courts and commentators have adequately addressed the general problem of valuation in tax and other areas,¹⁶⁶ and we need only outline the overall framework of the issue in order to determine the appropriate interpretation of section 1001.

The fundamental question is whether section 1001's valuation requirement is workable. The failure of the courts to adopt the suggested interpretation of section 1001 may reflect its unmanageability, and even the current confusion in the law would presumably be preferable to an internally consistent but impractical theory of taxation. The suggested approach, however, has an obvious practical benefit: it actually eliminates the need for valuations in any regular business transaction. In addition, the difficulties with determining fair market value in isolated transactions are not unique to this area of tax law, and other possible interpretations of the Code offer no easier solutions. In order to analyze the valuation problem, it is helpful to distinguish those situations in which a market for the obligation actually exists from those in which fair market value must be determined in another manner.

1. *Existence of a Market.* (a) *Formal markets.* The existence of a formal market for a specific purchaser obligation undoubtedly eases the valuation problem. In the extreme case of securities traded on a national securities exchange,¹⁶⁷ one can usually find within a few percentage points the amount the seller could have received for the obligation on any given day. Because section 1001 is designed to measure pecuniary gain, there is no reason to go beyond this market price in determining the fair market value of what the seller has received.¹⁶⁸ If the seller of the property decides to hold the obligation rather than sell it, the tax law might appropriately consider this a separate investment decision¹⁶⁹ and not embroil itself in the taxpayer's reasons for doing so.¹⁷⁰

165. This analysis assumes that the taxpayer does not elect the installment method.

166. For example, the Mertens tax service contains a separate 167-page chapter on valuation problems. 10 J. MERTENS, *supra* note 37, §§ 59.01-91 (1976) (chapter 59).

167. A formal market also exists when prices are widely quoted in an over-the-counter market.

168. As in all areas of the law, of course, one should not follow general principles blindly. The existence of market quotations, for example, does not necessarily mean that the holder of a large block either could have obtained, or would have been restricted to, the quoted price. *Cf. Bolles v. Commissioner*, 69 T.C. 342, 351-55 (1977) (market quotation discounted because stock subject to restrictions on transferability pursuant to Securities Act of 1933).

169. An actual sale would, of course, involve brokerage fees and other transaction costs, and these fees might constitute a major reason for the seller's decision to hold. In the established securities markets, however, these costs can probably be estimated with considerable accuracy and deducted from the fair market value determined from the daily transactions or quotations. The rationale for this method is that if the seller had actually sold, he would have received only the fair market value less the transaction costs involved in the sale.

170. Presumably, the main reason for holding a debt obligation that has a market price less

(b) *Quasimarkets*. Unfortunately, most individual sale-of-property transactions do not involve purchaser obligations traded in an established securities market, and a question then arises about the precise meaning of the term "market." Presumably, the value to be attributed to a purchaser obligation depends on the particular characteristics of the transaction¹⁷¹ and on the obligor's financial circumstances.¹⁷² Because financial circumstances vary from purchaser to purchaser and because most purchaser-obligors have only a small number of obligations outstanding at any given time, price quotations based on actual sales or bids of the type available in the national securities markets will be unavailable. Nevertheless, when the characteristics of the transaction, including the legal rights and obligations of the parties, are set forth in a standard form contract of a type bought and sold by a reasonable number of persons or firms in the community, it may be possible to define a "quasimarket" through arm's-length bids on a particular purchaser's obligation, even though no similar obligations of the same purchaser are outstanding or actively traded. If these bids are available, they should be used to determine fair market value under section 1001.¹⁷³ They establish what the seller could have obtained for the obligation had he chosen to dispose of it rather than to hold it, and the existence of this quasimarket greatly simplifies the otherwise thorny valuation determination.¹⁷⁴

than its face value is that the holder either believes that lower interest rates in the future will raise the price of the obligation or has more faith in the solvency of the obligor than does the market in general. In this case, the government might argue that the obligation was actually worth *more* to the holder than the market price, and this argument might leave the taxpayer with little incentive to raise considerations other than market price. It should be noted that current law goes even further than the discussion in the text indicates, in that it prohibits the use of the installment method of reporting when the obligation received by the seller is traded in an established securities market. See § 453(b)(3). Thus, the seller is not even permitted the investment choice of holding the purchaser obligation unless he independently has sufficient funds to pay the tax determined under section 1001.

171. Relevant characteristics of the transaction include the amount and type of security, the size of downpayment, the interest rate, and the term of the security.

172. Relevant financial circumstances include the obligor's balance sheet, income, and reputation for making payments when due.

173. This quasimarket exists primarily for certain types of real estate contracts. See, e.g., *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 789 (9th Cir. 1975); *Kaufinan v. Commissioner*, 372 F.2d 789, 793-94 (4th Cir. 1966); *Witte v. Commissioner*, 31 T.C.M. (CCH) 1137, 1140 (1972), *rev'd on other grounds*, 513 F.2d 391 (D.C. Cir. 1975); *Perelman v. Commissioner*, 41 T.C. 234, 237-38 (1963), *acq.* 1965-2 C.B. 6; *Estate of Ennis v. Commissioner*, 23 T.C. 799, 802 (1955) (finding no ascertainable fair market value notwithstanding the existence of a market), *nonacq.* 1956-2 C.B. 10. Presumably the value of these contracts inheres primarily in the quality of the underlying security rather than in the individual circumstances of the obligor.

174. Of course, in an established securities market, one need usually only refer to the *Wall*

2. *Absence of a Market.* Some courts have been reluctant to find cash equivalence in the absence of a formal market or a quasimarket because finding cash equivalence requires a complicated valuation without significantly serving the purposes of the cash-equivalence concept.¹⁷⁵ These considerations, however, do not apply to determinations of fair market value under section 1001. Cash equivalence is an accounting-provision concept designed to prevent distortion of income by taxpayers reporting on the cash method. As discussed above,¹⁷⁶ cash equivalence has no place in cases to which section 1001 applies; the standard set by that section is fair market value. While it may seem paradoxical to require a market for cash equivalence but not to require even a quasimarket in the determination of fair market value, the courts have never required the existence of a market to determine the fair market value of third-party obligations received in a sale-of-property transaction.¹⁷⁷ Consequently, there is no basis for such a requirement in the case of purchaser obligations.

In the absence of a market or quasimarket, however, fair market value must be determined by balancing the various characteristics of the transaction and the purchaser's financial circumstances. All of the factors might be brought under one verbal umbrella—the “speculative character” of the obligation or the “degree of risk” involved—but that hardly furthers the analysis, nor does it alter the fact that no one has developed an objective formula for weighing all of the relevant factors

Street Journal for the trading day in question. Obtaining bids in the type of quasimarket envisioned here may involve considerably greater effort. In fact, when bids have not been obtained at the time of the transaction, the arm's-length assumption totally breaks down, and one can at best seek an honest assessment, from people making a market in these obligations, of what they would have bid had they been asked. Nevertheless, the range of their estimates will be circumscribed by evidence of the types of transactions they did enter into around the date in question.

175. See text accompanying notes 139-40 *supra*. Consider, for example, the following language from *Denver & R.G.W.R.R. v. United States*, 318 F.2d 922 (Ct. Cl. 1963), concerning a rather special railroad “car note” issued to the taxpayer as a dividend:

The advantage of that general rule [requiring a market] is the relative ease and accuracy of determining when (and by how much) receipt of an obligation constitutes income. The test is the practical one of the market, in its broadest sense. To go further and require the current assessment of the worth of non-realizable or non-marketable obligations—instead of awaiting the actual receipt of money under those obligations—would thrust both taxpayers and the Internal Revenue Service into the briar-patch of valuation sans market.

Id. at 928. See also *McIntosh v. Commissioner*, 26 T.C.M. (CCH) 1164, 1179 (1967) (succumbing to the temptation to avoid valuation absent a market even in a sale-of-property context).

176. See text accompanying notes 140-44 *supra*.

177. See note 54 *supra* and the cases cited therein; see also text accompanying notes 143-44 *supra*.

together. In simple terms, valuation of purchaser obligations is a very difficult problem.

One is tempted to suggest the repeal of section 1001, leaving the determination of income upon the sale of property to the taxpayer's method of accounting. However, assuming that Congress would consider eliminating this longstanding provision, this approach would not be entirely free from objection. In transactions outside the regular course of the taxpayer's business, this approach would leave two otherwise similarly situated taxpayers in radically different tax positions simply because they chose different accounting systems. Their tax consequences would differ even though the transaction in question is totally unrelated to the business or employment for which the accounting method was chosen. If these similarly situated taxpayers are to be treated equally, further steps are necessary.

(a) *Cash-method approach.* These taxpayers would be treated the same if all casual or isolated transactions were governed by the cash method, regardless of the accounting system used in the taxpayer's regular business. This equalizing rule, however, might result in a significant loss of revenue.¹⁷⁸ This approach would also put heavy pressure on the definition of a casual transaction, since the possibility of deferral would sorely tempt accrual-method taxpayers to arrange large sales with unusual features in an effort to qualify them as transactions outside the ordinary course of business. The litigation on this issue could rival that under section 1001 by cash-method taxpayers. Finally, as a practical matter, this approach is unrealistic because it would surely receive the strongest possible opposition from the Treasury Department¹⁷⁹ and is therefore highly unlikely ever to get through Congress.

(b) *Accrual-method approach.* A second approach would be to apply a pure accrual system to all sales transactions—that is, to require all taxpayers to include the full face amount of the purchaser obligation in income in the year of sale. This rule, however, would often be econom-

178. The loss of revenue in any year would be the difference between the tax based on the current fair market value of the purchaser obligation and the present value of the tax to be assessed against future payments representing the taxpayer's gain from the transaction. Because the cash method is always better for the taxpayer in that he recovers his basis before recognizing any gain, this approach would also completely obviate the need for an installment method election in the case of casual sales. *E.g.*, *Johnston v. Commissioner*, 14 T.C. 560, 564 (1950).

179. The Treasury Department has, in fact, proposed the exact opposite, that the cost-recovery method of reporting gain, which produces the same results as the cash method, be statutorily barred in the case of property sales. See text accompanying notes 263-65 *infra*.

ically unrealistic and might actually be unconstitutional.¹⁸⁰ For example, when the purchaser obligation has a fair market value considerably less than the face amount,¹⁸¹ the taxpayer would be taxed on a gain that is in no way related to an actual increase in his present wealth. Moreover, this approach would be as one-sidedly favorable to the government as the cash-method approach would be to the taxpayer, and a large number of transactions would require a recognition of loss in subsequent years when the obligation is ultimately disposed of or the transaction is finally closed.¹⁸² Thus, although the valuation problem could be eliminated by going to a pure cash or to a pure accrual ap-

180. Assuming that the realization requirement of *Eisner v. Macomber*, 252 U.S. 189 (1920), still has meaning, it is difficult to see how the taxpayer can be said to have realized any amount above the value of the obligation received. He can get no more for the obligation than its value, even assuming that he is actually able to sell it for the ascertained value. Moreover, the Supreme Court has included in the term "income" under section 61(a) items that constitute "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Amounts exceeding the value of the obligation received do not satisfy this sufficiency standard in either of its first two elements. There is no accession to wealth beyond the value of the purchaser obligation, at least if wealth is measured in a pecuniary sense for tax purposes; and there is no realization, as discussed above. Moreover, because there is no accession to wealth and no realization, the only thing above the value over which the taxpayer could have dominion, complete or otherwise, is a valueless right to payment in the future.

Logically, it might appear that these arguments apply equally to the accrual method itself, and that this method is therefore also of questionable constitutionality. However, the analogy holds only insofar as the sixteenth amendment requires income to be measured on a transaction-by-transaction basis. In fact, however, the sixteenth amendment empowers Congress "to lay and collect taxes on income," and this clause has long been interpreted to refer to income ascertained on the basis of fixed accounting periods rather than from particular transactions. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364-65 (1931). As applied to a series of related transactions over a given period, the accrual method, consistently applied, is not an unreasonable measure of the income actually received during the period. See notes 43-45 *supra* and accompanying text. Accounts receivable in a given year are taken into income at face value, less an allowance for doubtful accounts. This is more or less balanced by money actually received from prior period sales that is not included in income. No claim can be made that the accrual method gives a reasonable measure of income from isolated transactions. By definition, the consistency necessary to make sense of an accounting system is lacking. Consequently, income from isolated transactions is distorted by automatic valuation at face, not only when measured on a transaction-by-transaction basis but also when measured over the annual accounting period. The same is not true for sales in the regular course of business.

181. This low fair market value might even be determined in a formal market.

182. The word "closure" is used loosely in this context to refer to any set of conditions in which it is clear that the seller will receive no further amounts of money or property from the purchaser out of the transaction. Thus, the transaction might become closed by the bankruptcy of the purchaser.

The noncorporate taxpayer would be at a further disadvantage under this system because current law does not permit noncorporate taxpayers a capital loss carryback. A taxpayer might have a large capital gain in the year of sale (face value less basis) and a large capital loss in a later year when part of the obligation goes unsatisfied. Because we are dealing with isolated transactions, the particular taxpayer may never have another capital gain large enough to permit him to enjoy a tax benefit to the full extent of this loss. He could, of course, use part of his loss to offset

proach for all casual sales of property, there would necessarily be significant undesirable effects in related areas.

(c) *Installment-method approach.* A final method of eliminating the need for a section 1001 valuation would be a compulsory form of the installment sale method.¹⁸³ Under this approach, every money payment by the purchaser¹⁸⁴ would be divided into return of capital and income in the same proportion that the seller's basis in the property sold bears to the total contract price. This analysis would change the current law in three ways. First, it would apply the installment sale method to losses as well as gains.¹⁸⁵ Second, it would eliminate the current restrictions on the use of the installment sale method—the 30% downpayment limitation, the two-payment rule, and the fixed-total-price requirement—because by hypothesis the installment approach would be the sole method of reporting income from the sale of property. Finally, it would remove the option taxpayers now have either to structure the transaction to qualify for the installment method or to report gain immediately, as measured by the fair market value of the purchaser obligation.

It is difficult to find intrinsic theoretical objection to either of the first two changes. Permitting installment reporting of losses might benefit taxpayers who anticipate future gains, but the circumstances in which this benefit would accrue are rare.¹⁸⁶ In addition, it may be ap-

ordinary income in each future year, but this use is limited and of little value to taxpayers with very large recognized losses or short life expectancies. §§ 1211, 1212.

183. One of the purposes of the installment provisions was to eliminate the need for appraisals of the purchaser obligations received. S. REP. NO. 52, *supra* note 37, at 19, 1939-1 C.B. (pt. 2) at 347; *see* Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 503 (1948).

184. Actual or imputed interest would of course first be excluded.

185. Section 453 refers only to the return of income and not to losses; for this reason it appears to have been settled fairly early that losses could not be spread through the installment approach. *Sacks v. Burnet*, 66 F.2d 223, 224 (D.C. Cir. 1933); *Martin v. Commissioner*, 61 F.2d 942, 944 (2d Cir. 1932), *cert. denied*, 289 U.S. 737 (1933). The Service has ruled similarly, although without giving any reason. Rev. Rul. 79-92, 1979-1 C.B. 180; Rev. Rul. 70-430, 1970-2 C.B. 51.

186. Current law restricts corporate capital loss carryforwards to five years, although individual carryforwards continue indefinitely. § 1212. Consequently, a corporation that could foresee a capital gain more than five years in the future but not before (including the *past* three years, for which there is a carryback), could benefit by reporting a realized capital loss on an installment basis.

The potential advantages to an individual are even more limited. An advantage could accrue, however, to an individual who has a capital loss and a capital gain in the same year. Assume that the taxpayer also has low ordinary income in that year and is in a relatively low tax bracket. If he can foresee a future increase in his ordinary income and capital gain in the same years, he might be better off postponing recognition of the loss. Because he will be in a higher tax bracket in later years, offsetting his loss at that time will effect a greater reduction in his tax liability. Even in this case, of course, the potential gain from the difference in tax brackets is partially offset by his delay in utilizing the tax loss. In any event, there are probably few of these cases.

propriate to relax or eliminate many of the restrictions on the availability of the installment-method alternative even if section 1001 is retained.¹⁸⁷ Thus, the primary cost of excising section 1001 from the Code is the elimination of the taxpayer's option to report gain immediately.¹⁸⁸

The elimination of this option, however, would be a serious imposition on the taxpayer, and on balance, retention of section 1001 would be a better course. The valuation problems under section 1001 are not so difficult as to justify its repeal, primarily because the burden is on the taxpayer to prove that the Service's assessment of tax liability is incorrect.¹⁸⁹ This rule significantly eases the court's valuation problem: if either or both parties introduce hard evidence of value, the court has a solid basis for its decision. If neither side introduces such evidence, the court simply holds for the Service. Because the taxpayer is in the best position to build the kind of record necessary to establish value, this rule makes particularly good sense.¹⁹⁰ By hypothesis, the taxpayer wishes to report under section 1001 and to risk having to pay a deficiency or having to litigate under a heavy burden of proof should the Service infer a different fair market value from the evidentiary record. Because this option has been available for over fifty years, only a strong policy reason should deny the taxpayer this choice.

If all valuations could be eliminated, or at least those valuations associated with the sale of property, the policy choice might change to favor the mandatory approach, but this is plainly not the case. There would still be a need to evaluate third-party obligations received upon a sale of property. Even if an installment method could be devised for them too,¹⁹¹ the problem of valuing property other than an obligation

187. See notes 247-54, 296-97 & 302-08 *infra* and accompanying text.

188. The Treasury Department has proposed amendments to section 453 that would to a large extent make the installment method mandatory for gains, at least from real property sales; only a form of the accrual method would be available as an alternative. See text accompanying notes 270-76 *infra*.

189. In general, the taxpayer may litigate a deficiency asserted by the Service in the Tax Court without paying it beforehand, or he may pay it and sue for a refund in a federal district court. *E.g.*, A. KRAGEN & J. McNULTY, *FEDERAL INCOME TAXATION* 1264 (3d ed. 1979). Under the Tax Court's rules of practice, the taxpayer generally carries the burden of proof. T.C. RUL. PRAC. & PROC. 142. See also *Niederkrome v. Commissioner*, 266 F.2d 238, 241 (9th Cir. 1958), *cert. denied*, 359 U.S. 945 (1959). In a suit in the district court for a refund, not only must the taxpayer prove that the Service's determination was erroneous, he also must establish facts upon which the correct determination can be made. *E.g.*, *Helvering v. Taylor*, 293 U.S. 507, 514-15 (1935); *cf.* *Bar L. Ranch, Inc. v. Phinney*, 426 F.2d 995, 998 (5th Cir. 1970) (double-pronged burden of proof on taxpayer too stringent when taxpayer challenges correctness of tax as defense in collection suit). See generally 10 J. MERTENS, *supra* note 37, § 58A.35 (1976).

190. See *United States v. Lease*, 346 F.2d 696, 700 (2d Cir. 1965).

191. In principle, it should be possible to treat a third-party obligation in the same way as a

to pay money, such as stock of a close corporation, would remain. Valuation is a difficult but inevitable part of our tax law.¹⁹² It is not worthwhile to make a fundamental policy change to eliminate only some of the transactions calling for valuation of property.

VI. IMPLICATIONS IN RELATED AREAS

A. *Open/Closed Transaction Distinction.*

Under section 1001 a sales transaction is usually considered open if the third-party or purchaser obligation does not have an ascertainable fair market value when the seller receives it; otherwise it is closed. The benefits of the open characterization are well known. First, the taxpayer recognizes no gain until he receives his basis, and thereafter only as he receives payments on the obligation. Second, payments on the obligation remain part of the original sale or exchange, so the seller retains capital gain treatment for all payments if the property sold was a capital asset.¹⁹³

In principle, at least, acceptance of the suggested interpretation of section 1001 would not affect the open/closed transaction distinction. First, consider sales in the regular course of business. Under the suggested approach, section 1001 would never apply to regular sales, and therefore open-transaction analysis under section 1001 would never be necessary. However, when the purchaser obligations are such that the open-transaction doctrine would otherwise be appropriate, the accounting provisions lead to the same results as section 1001 analysis. Currently, a transaction is likely to be held open under section 1001 only if the total amount to be paid on the obligation is indefinite.¹⁹⁴ Pursuant

purchaser obligation under section 453, with each payment split into return of capital and income in accordance with the seller's basis in the property sold and the total contract price. Under this analysis, the contract price would include the face amount of the third-party obligation. The courts, however, have never taken this approach. The installment sale provisions have always been limited to purchaser obligations, and the fair market value of a third-party obligation must be included as part of the payment in the year of sale. *E.g.*, *Tombari v. Commissioner*, 299 F.2d 889, 891 (9th Cir. 1962); *Simpson v. Commissioner*, 35 T.C.M. (CCH) 710, 717 (1976).

192. Even the Supreme Court in *Burnet v. Logan*, 283 U.S. 404 (1931), the most venerable authority for avoiding valuation problems when possible, recognized the need to value purchaser obligations for the purpose of calculating the estate tax. *Id.* at 413. Other common situations requiring valuation include the allocation of basis among various securities received on a tax-free reorganization or transfer to a controlled corporation, *e.g.*, *Helvering v. Taylor*, 293 U.S. 507 (1935), and the separate valuation for depreciation purposes of land and improvements or of all the assets of a business purchased as a unit, *e.g.*, *Walsh v. Commissioner*, 33 T.C.M. (CCH) 728 (1974).

193. *E.g.*, M. CHIRELSTEIN, *supra* note 60, at 301-03.

194. *E.g.*, *Burnet v. Logan*, 283 U.S. 404, 413 (1931) (open-ended mineral royalty); *Westover v. Smith*, 173 F.2d 90, 91 (9th Cir. 1949) (lower court's finding of no ascertainable fair market value in percentage-royalty contract not challenged by Service); *Commissioner v. Carter*, 170 F.2d

to the accounting provisions, an accrual-method taxpayer includes an item in income only when the amount can be determined with reasonable accuracy,¹⁹⁵ and a cash-method taxpayer includes payments only as received. Therefore, for transactions in the regular course of business, the accounting methods and the current open-transaction approach give identical results.¹⁹⁶ Consequently, for regular sales the suggested approach will change only the doctrinal analysis, not the result.

Consider next the case of isolated sales. Here the suggested approach dictates that section 1001 govern, but nothing in the approach poses a logical bar to application of the open-transaction doctrine. Section 1001 requires that gain or loss be measured by the fair market value of the purchaser obligation, but it says nothing about what to do when such value is not ascertainable. If there is a case of true nonascertainability, there is no choice under the current statutory scheme other than to leave the transaction open.¹⁹⁷

One must be careful, however, not to blur the analysis. First, to say that the fair market value of an obligation is not ascertainable is fundamentally different from saying that the value is zero. If the obligation in fact has zero value, the transaction should still be closed and gain or loss measured in precisely the same way as for any other fixed

911, 911 (2d Cir. 1948) (parties stipulated to absence of ascertainable fair market value in oil brokerage contracts); *MacDonald v. Commissioner*, 55 T.C. 840, 860-61 (1971) (sale price of patent rights dependent on amount manufactured under the patent), *acq.* 1973-2 C.B. 2; *Dorsey v. Commissioner*, 49 T.C. 606, 629 (1968) (sale of equipment for a percentage of future receipts). The same result obtains if the uncertainty is in the taxpayer's right to receive the payment. *E.g., In re Steen*, 509 F.2d 1398, 1403 (9th Cir. 1975); *Bolles v. Commissioner*, 69 T.C. 342, 356 (1977).

195. Treas. Reg. § 1.446-1(c)(ii) (1957).

196. A case involving fixed-price contracts, like *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979), discussed in text accompanying notes 85-95 *supra*, would in fact arrive at different results for an accrual-method taxpayer depending on whether (1) the accounting method applies or (2) section 1001 applies and taxation thereunder is delayed because the transactions are considered open. No court, however, has ever applied section 1001 to an accrual-method taxpayer. See text accompanying notes 102-07 *supra*. Moreover, notwithstanding cases that have found fixed-price contracts to have no ascertainable value, *e.g., McShain v. Commissioner*, 71 T.C. 998 (1979), discussed in text accompanying notes 81-84 *supra*, the discussion in the text *infra* indicates that a finding of nonascertainability of value is often difficult to justify even for contingent-price contracts. See text accompanying notes 224-28 *infra*. Honest analysis and the always available option of reporting under section 453 make such a finding almost totally unjustified in the case of a fixed-price contract.

197. The uniform litany is that whether a particular contract or obligation has an ascertainable fair market value is a question of fact rather than law. *See, e.g., Riss v. Commissioner*, 368 F.2d 965, 970-71 (10th Cir. 1966); *Estate of Marsack v. Commissioner*, 288 F.2d 533, 535 (7th Cir. 1961). See also text accompanying note 60 *supra*. Therefore, it is always theoretically possible to receive open-transaction treatment, especially now that the Tax Court appears to be more receptive to the argument. See notes 81-95 *supra* and accompanying text.

dollar value.¹⁹⁸ Second, as pointed out above,¹⁹⁹ the traditional reliance on *Burnet v. Logan*²⁰⁰ as a basis for the open-transaction doctrine is without foundation in the current statutory scheme.²⁰¹ Third, it would be incorrect to conclude that an obligation does not have an ascertainable value at a given time simply because it is possible that the assessment of value might change with future developments. The market value of even a publicly traded security will vary with new information about the company.²⁰² The issue in every sales transaction is whether, at the time of the transaction, a reasonable assessment of value can be made based on the information then available. In fact, given the wide variety of valuation techniques, there are probably few cases in which a reasonable assessment cannot be made. The real problem frequently is that penalties will attach to an assessment that later turns out to have been greatly in error. This may explain why courts are sometimes inclined to find that the value is not ascertainable. However, the existence of an ascertainable value is not rationally related to the problem of unfair penalties. Rather, it is the *fairness* and not the existence of an ascertainable value under section 1001 that must serve as the focus for analysis and as the basis for maintaining all or part of the open-transaction doctrine. The next section carries out this analysis

198. See note 59 *supra*.

199. See text accompanying notes 97-101 *supra*.

200. 283 U.S. 404 (1931).

201. There are undoubtedly many cases in which both the taxpayer and the Service will agree that a purchaser obligation has no ascertainable fair market value, perhaps because neither side wishes to address the difficult valuation question. *E.g.*, *Gralapp v. United States*, 458 F.2d 1158, 1159-60 (10th Cir. 1972) (value of contingent additional payment on sale of oil lease stipulated to have no ascertainable fair market value at time of sale); *Frost v. Commissioner*, 37 B.T.A. 190, 191 (1938) (Service did not question claim of nonascertainability of fair market value even in the case of fixed-price contracts), *acq.* 1938-2 C.B. 12. In these circumstances, there seems to be no reason for a court unilaterally to refuse to allow the traditional open-transaction approach apparently acceptable to both sides. The suggested approach to the interpretation of section 1001 certainly does not bar the open-transaction method in this form. However, there is no way to know in advance just when the Service will adopt this friendly position. Therefore, to rely solely on a test of nonascertainability of fair market value invites different results for similarly situated taxpayers in a manner that is inconsistent with any rational theory of taxation.

202. For example, in the famous case of *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968), the public market price for the company's common stock went through a rapid rise over the few months during which knowledge of insider trading activity and the scope of the actual mineral finds became public. Nevertheless, anyone who exchanged property for Texas Gulf Sulphur stock in the middle of the price rise should have had gain measured by the market price on the day of exchange. Such a taxpayer might argue that the "true value" was speculative or changing, but the parties presumably would have negotiated their transaction on the basis of the then-available information, including the then-current public market price. Because the seller could have realized that price in cash on the date of the transaction, the same amount should be the fair market value for section 1001 purposes, notwithstanding that fast-flying rumors made the value speculative.

in detail.²⁰³ It suffices to state here that reliance on avoidance of unfair penalties as a basis for the open-transaction doctrine permits a more rational analysis of the doctrine's benefits, the limits that might appropriately be placed on it, and possible alternatives.

B. *Character and Timing of the Discount Payments.*

Under the suggested interpretation, section 1001, unadulterated by accounting-method concepts, would govern in all isolated sales transactions, with statutory relief coming solely from the installment sale provisions of section 453. In addition, because most if not all purchaser obligations have a value that can be assessed reasonably on the basis of the information available at the time of the transaction, the traditional basis for applying the open-transaction doctrine would be undercut. Therefore, the model for taxing isolated transactions not subject to section 453 would be the same as the method currently applied to closed transactions: the seller would recognize gain or loss in the year of sale, and the amount would be measured by the difference between the ascertained fair market value of the purchaser obligation and the seller's basis in the property sold.²⁰⁴ The seller would then acquire a basis in the purchaser obligation equal to the ascertained fair market value and would recognize additional gain or loss in subsequent years to the extent that the total payments made by the purchaser²⁰⁵ differed from the basis acquired in the purchaser obligation. The crucial question here is whether such treatment under section 1001 of all non-installment-method isolated sales constitutes a sound tax policy. In other words, are there undesirable implications of the suggested approach that outweigh the arguments in its favor?²⁰⁶

In attempting to answer this question, two judicial doctrines that embellish the method of taxing closed transactions must be reviewed. The first is the doctrine that any amount that the seller receives subsequent to the sale above his basis in the purchaser obligation²⁰⁷ is ordinary income. For convenience, we will refer to any such amount as a

203. See text accompanying notes 241-58 *infra*.

204. For simplicity, assume that the purchaser obligation is the only item received by the seller at the time of the sale. Then gain or loss equals the difference between basis and fair market value. See note 12 *supra*.

205. In calculating gain or loss, actual or imputed interest would be subtracted from the total of the payments made by the purchaser.

206. The arguments in favor of the suggested approach are summarized in the text accompanying notes 154-157 *supra*.

207. This amount will be equal to the ascertained fair market value of the purchaser obligation on the date of the sale.

“discount payment.”²⁰⁸ The second is the doctrine that the total gain represented by the difference between the face amount of the purchaser obligation and the ascertained fair market value on the date of sale must be amortized over the period of payment unless the purchaser obligation is speculative. We will refer to the difference between the face amount of the purchaser obligation and the ascertained fair market value on the date of sale as the “discount.”

The analysis that follows leads to two principal conclusions. First, it is useful in characterizing the discount to divide the types of purchaser obligations into fixed-price contracts, in which the only contingency is whether the purchaser will fulfill his legal obligations, and contingent-price contracts, in which there is a risk of nonpayment even though the purchaser fulfills his legal obligations. For fixed-price contracts, the discount bears a strong analogy to interest. Moreover, for these types of purchaser obligations, the seller is almost invariably in a position to maintain capital gain treatment for all discount payments by electing to report under the installment method of section 453. It is therefore not unreasonable to treat the discount payment as ordinary income when gain is reported under section 1001. For contingent-price contracts, on the other hand, the analogy to interest is much weaker, and the installment method of reporting is often unavailable. There is a strong case, therefore, for treating discount payments on contingent-price contracts as capital gain if the seller would otherwise be entitled to capital-gain treatment. The suggested rationale is a modified form of the open-transaction doctrine: a contingent-price contract should be treated as open if and to the extent the Service deems it ineligible for the installment method of reporting.²⁰⁹ The second principal conclusion is that speculativeness is an inadequate test to determine whether the discount should be amortized over the term of the obligation. Rather, a coherent reading of section 1001 and 453 suggests that proration should not be required for purchaser obligations but probably should be required for third-party obligations. The much more difficult discount-characterization question is taken up first.

208. Others use the term “collection gain.” See notes 264 & 280 *infra*.

209. Existing legislative proposals to amend section 453 of the Code, if enacted, would in essence lead to the same results as the analysis suggested by this Article. The analysis concerning the character of the discount payments proceeds on the assumption that the Code will retain the form it had in January 1980, that is, that Congress will not pass the legislation. Footnotes are included, however, to indicate points at which a proposed legislative change would affect the analysis, and a more coherent discussion of the proposed amendments and their effect on the thesis presented in this Article is included as a separate subsection. See text accompanying notes 259-82 *infra*.

1. *Character of the Discount—Discount Payments as Ordinary Income.* Once a purchaser obligation has been valued in a closed transaction and included in the measure of gain for the year of sale, the theoretical basis for taxing the discount payments²¹⁰ as ordinary income is that there is no sale or exchange, a necessary element in the capital gain preference.²¹¹ Professor Rabinovitz has cogently pointed out²¹² the inconsistency between this doctrine and the rationale underlying the famous Supreme Court case of *Arrowsmith v. Commissioner*,²¹³ in which the Court held that the character (ordinary or capital) of a deductible loss in a current tax year can be determined by reference to a transaction in a prior year to which the current loss is integrally connected. The *Arrowsmith* rationale applies with equal force to subsequent gains, and receipts on a purchaser obligation following a closed transaction seem to be even more strongly related to the original underlying sale than the transactions in *Arrowsmith* were to each other.²¹⁴ Therefore, if the original sale involves a capital asset, the *Arrowsmith* rationale strongly suggests that all discount payments should receive capital gain treatment.

Nevertheless, as Professor Rabinovitz points out,²¹⁵ the tradition of treating these excess payments as ordinary income appears firmly established, and reconciliation of the conflicting doctrines may require

210. The term "discount payments" is defined in the text accompanying note 208 *supra*. Stated in slightly different words, discount payments are amounts received by the seller on a purchaser obligation subsequent to a closed transaction that are not treated as a return of seller's basis in the purchaser obligation. The seller's basis in the purchaser obligation is the ascertained fair market value of the purchaser obligation included in the amount realized for purposes of reporting gain or loss under section 1001 in the original closed transaction. The term "purchaser obligation" refers throughout this Article to a debt instrument received directly from the purchaser in a sale-of-property transaction in full or partial exchange for the property transferred and on which the purchaser is the obligor.

211. *E.g.*, *Osenbach v. Commissioner*, 198 F.2d 235, 237 (4th Cir. 1952) (third-party claims distributed on corporate liquidation). *See also* *Hudson v. Commissioner*, 20 T.C. 734, 736 (1953) (payment received on settlement of a judgment debt acquired by purchase), *aff'd sub nom.* *Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954).

212. Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequence of Current Receipts or Payments*, 28 TAX. L. REV. 85 (1972).

213. 344 U.S. 6 (1952). The original transaction in *Arrowsmith* was a corporate liquidation; the shareholder-taxpayers recognized long-term capital gain upon their acquisition of the corporate assets. The related transaction in the subsequent year was the payment by the taxpayers, as transferees of the corporate assets, of a judgment rendered against the corporation after the liquidation. Taxpayers sought an ordinary business deduction for the later payment of the judgment, but the Supreme Court held that because it arose out of the liquidation proceedings, the payment was deductible only as long-term capital loss. Thus, *Arrowsmith* deals with neither the amount nor the timing of an income or deduction item; the case says simply that the *character* of the item may be determined by its relation to a prior transaction.

214. Rabinovitz, *supra* note 212, at 97-101.

215. *Id.*

additional guidance from Congress.²¹⁶ The result is to put the taxpayer

216. Significant statutory assistance already exists. Section 1232(a) treats amounts received by the holder of corporate evidences of indebtedness when the debt is retired as amounts received in exchange for the debt. Therefore, if the debt instrument is a capital asset in the hands of the holder, amounts received in payment on retirement (excluding any original issue discount) will be capital gain to the extent that they exceed the holder's basis. Even a series of payments on a corporate obligation may each be treated as for the purpose of retiring the obligation. *Cf.* *Riss v. Commissioner*, 24 T.C.M. (CCH) 1020, 1020 (1965) (stipulation that each monthly payment on an 11-year installment note issued on redemption of corporate stock was for the purpose of retiring the note within the meaning of section 1232(a)), *aff'd*, 368 F.2d 965 (10th Cir. 1966). Proposals have been made to extend the benefits of section 1232(a) to recipients of notes of individual as well as corporate obligors. See note 280 and text accompanying notes 264 & 266 *infra*.

The preponderance of authority supports the general proposition that payments on a note are ineligible for the capital gain preference because they do not involve a sale or exchange in the year of payment. Most of this authority, however, does not deal with situations involving payments on purchaser obligations—obligations given by a purchaser directly to a seller in full or partial payment for property sold. Moreover, disallowing the capital gain preference for payments on purchaser obligations is the only situation that directly conflicts with the *Arrowsmith* rationale. Thus, there is yet room to argue that the *Arrowsmith* rule supplies the necessary sale-or-exchange element to purchaser obligation payments.

It is important to distinguish the rulings in cases like *Fairbanks v. United States*, 306 U.S. 436, 437 (1939), in which the courts have held (prior to the adoption of section 1232(a)), that redemption of a corporate bond purchased for money does not involve a sale or exchange. In these cases the bondholder made no underlying sale of property to which the redemption payment could relate. Similarly, payments on third-party notes purchased for cash do not relate to an underlying sale-of-property transaction by the recipient of the payments. A large number of cases can be distinguished from those involving purchaser obligations on this ground. *E.g.*, *Darby Inv. Corp. v. Commissioner*, 315 F.2d 551 (6th Cir. 1963); *Willhoit v. Commissioner*, 308 F.2d 259 (9th Cir. 1962); *Phillips v. Frank*, 295 F.2d 629 (9th Cir. 1961); *Underhill v. Commissioner*, 45 T.C. 489 (1966). As Professor Herwitz has pointed out, D. HERWITZ, *BUSINESS PLANNING* 503 (1966), for purposes of requiring amortized recognition of the discount, there may be no distinction between the cases involving third-party notes purchased for cash and those involving purchaser obligations received in exchange for property; the obligation is essentially purchased either for cash or for property in any event. For purposes of determining the character of the discount, however, the distinction may be crucial. The *Arrowsmith* rationale arguably supplies the necessary sale or exchange in the case in which property has been exchanged for a note, but not in cases in which a note has been purchased for cash.

The *Arrowsmith* rationale also does not necessarily apply to those cases in which a third-party obligation is received in exchange for property. The most common example of this situation is the receipt of a royalty or similar contract upon the liquidation of a corporation. *E.g.*, *Waring v. Commissioner*, 412 F.2d 800 (3d Cir. 1969); *Slater v. Commissioner*, 356 F.2d 668 (10th Cir. 1966); *Tombari v. Commissioner*, 299 F.2d 889 (9th Cir. 1961); *Campagua v. United States*, 290 F.2d 682 (2d Cir. 1961); *Estate of Marsack v. Commissioner*, 288 F.2d 533 (7th Cir. 1961); *Clamberlin v. Commissioner*, 286 F.2d 850 (7th Cir.), *cert. denied*, 368 U.S. 820 (1961); *Gersten v. Commissioner*, 267 F.2d 195 (9th Cir. 1959); *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952); *McCormac v. Commissioner*, 67 T.C. 955 (1977); *Rev. Rul. 58-402*, 1958-2 C.B. 15. In these cases the taxpayer has indeed exchanged property: he has exchanged his stock for the contractual obligation of a third party. The payment made by the third-party obligor on the contract, however, is not in any way incident to the exchange between this taxpayer and the corporation. For example, in the corporate liquidation setting, the obligor would have been bound to make his contractual payment to the holder of the contract whether or not there had been an exchange in a liquidation transaction. See *Campagua v. United States*, 290 F.2d 682, 685 (2d Cir. 1961) (refusing to apply *Arrowsmith* to payments made on a mortgage received in a corporate liquidation on the ground

in a well-known dilemma: either he reports a high value for the pur-

that the payments did not involve any modification or adjustment of the underlying mortgage obligation). See also *Lowe v. Commissioner*, 44 T.C. 363, 374 n.6 (1965), *acq. in result* 1966-1 C.B. 2. In addition, when the taxpayer exchanges his stock in liquidation and reports the fair market value of the contract as part of his amount realized under section 1001, his relationship with the other party to the exchange (the corporation) is over; in other words, the sale is arguably completed. Therefore, subsequent payments on the contract are not so integrally related to the exchange of stock that *Arrowsmith* compels capital gain treatment.

Admittedly, this distinction between third-party obligations and purchaser obligations is not so strong that it could not be overcome if there were strong policy reasons for applying the *Arrowsmith* rationale to these cases. It does no great offense to either logic or language to conclude that the payments on third-party obligations "arise out of" or are "integrally connected with" the underlying exchange transaction. The discussion in the text *infra*, however, suggests that policy should be looking in the other direction—that is, to restricting the scope of judicial gloss in sales transactions and extending the availability of the installment method as the primary means of relieving the harsh effects of section 1001. See text accompanying notes 244-58 *infra*. If we continue to permit use of the installment method—in which the gain recognized on each payment retains the character of the underlying sale—only for purchaser and not for third-party obligations, that policy choice would also seem to militate against applying the *Arrowsmith* rationale to subsequent payments received on third-party obligations obtained in a closed transaction under section 1001. Moreover, to give capital gain treatment to the discount payments received on third-party obligations obtained upon corporate liquidation would compound a defect already present in the corporate liquidation rule, which permits the corporation in some circumstances to escape tax on what is ordinary corporate business income. See M. CHIRELSTEIN, *supra* note 60, at 303-04.

This analysis leaves, then, only a small number of cases in which discount payments on purchaser obligations have been held to constitute ordinary income on the ground that the payments did not involve a sale or exchange. There are, in fact, surprisingly few post-*Arrowsmith* cases in which the underlying transaction involved a sale of property in a closed transaction and in which the character of subsequent payments on the purchaser obligation was an issue. Two Tax Court cases have involved stipulations by the parties that the discount constituted ordinary income, so that the only issue the court decided was whether the discount had to be recognized pro rata from each payment or whether taxpayer's basis could be recovered first. *Witte v. Commissioner*, 31 T.C.M. (CCH) 1137, 1142-43 (1972), *rev'd on other grounds*, 513 F.2d 391 (D.C. Cir. 1975); *Potter v. Commissioner*, 44 T.C. 159, 174 (1965), *acq.* 1966-1 C.B. 3. Only one case known to this author appears factually on point, and any rejection of *Arrowsmith* it may contain is only implicit, as the argument was not directly raised. The Fifth Circuit held that subsequent payments on a note that qualified as a security for purposes of nonrecognition under section 351 (transfer of property to a controlled corporation) were ordinary income. *Dennis v. Commissioner*, 473 F.2d 274, 287 (5th Cir. 1973). The *Dennis* case is arguably distinguishable from the transactions analyzed in this Article: a section 351 transfer is not, strictly speaking, a section 1001 closed transaction, because section 351 is an exemption from the recognition requirement of section 1001. Nevertheless, this distinction lacks force. The gain ultimately arises out of the corporation's acquisition of the underlying assets for stock plus the note, and thus out of a sale or exchange of those assets. Moreover, payment comes directly from the purchaser corporation and is therefore integrally related to the underlying exchange transaction. On the facts of the case, therefore, the court in *Dennis* held the *Arrowsmith* rationale inapplicable to discount payments arising out of a property exchange transaction. However, although the taxpayer in *Dennis* made several highly sophisticated arguments, none were based on *Arrowsmith*, and one might therefore argue that the court did not have a fair opportunity to consider its potential application.

At least two pre-*Arrowsmith* cases held that a subsequent loss on notes previously included in income of the seller in the year of property sale was not a capital loss because extinguishing the notes for a payment less than face did not involve a sale or exchange. *Binghan v. Commissioner*,

chaser obligation in the year of sale—perhaps without having received

105 F.2d 971, 972 (2d Cir. 1939); *Hale v. Helvering*, 85 F.2d 819, 821-22 (D.C. Cir. 1936). The Service apparently continues to follow this view, at least officially. See Rev. Rul. 56-531, 1956-2 C.B. 983; Pvt. Ltr. Rul. 7745009, 1977 Fed. Taxes: Private Letter Rulings ¶ 256(77); I.T. 4018, 1950-2 C.B. 20, *declared obsolete*, Rev. Rul. 69-43, 1969-1 C.B. 310. These cases are of questionable authority, however, in light of later decisions reaching the opposite result on the basis of the *Arrowsmith* rule. See *Wener v. Commissioner*, 242 F.2d 938, 945-46 (9th Cir. 1957) (negotiated reduction, in return for immediate payment, of amount due on purchaser obligation previously taken into income at a loss held to be a capital loss as part of the original sales transaction); *Smith v. Commissioner*, 48 T.C. 872, 880 (1967) (purchaser obligation taken into income in year of sale but prepaid in a later year at a discount in accordance with the original contract terms results in capital loss, by reference to the original sales transaction), *rev'd on other grounds*, 424 F.2d 219 (9th Cir. 1970). Admittedly, these later cases involved renegotiated discount or discount in accordance with the original contractual terms, while the pre-*Arrowsmith* cases involved compromises of disputed claims or actual default by the purchaser. Nevertheless, there is nothing in the *Arrowsmith* rationale that would justify distinguishing the character of the subsequent losses on this basis, notwithstanding the *Wener* court's attempt to make such a distinction with respect to *Hale*, 242 F.2d at 943, 946. Even the Service, in a case that may come back to haunt it, has recently argued that a default subsequent to a closed sales transaction should be treated as a capital loss because of its capital transaction origins. *Grudberg v. Commissioner*, 34 T.C.M. (CCH) 669, 673 (1975). Moreover, *Arrowsmith* has been relied on in other contexts to treat deductible expenses incurred in relation to an underlying sales transaction as capital loss. *E.g.*, *Bird v. Commissioner*, 22 T.C.M. (CCH) 65, 68-69 (1963) (payment of corporate expenses to facilitate sale of corporate stock is in effect a reduction of the sale price and a capital loss because related to the sale of a capital asset); *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422, 424 (1953) (payments made in year subsequent to sale of real property pursuant to warranty deed are an outgrowth of the sale of the underlying property and therefore capital loss). Consequently, there is abundant authority for the proposition that, under the *Arrowsmith* rationale, subsequent losses related to payment or satisfaction of a purchaser obligation previously taken into income in connection with a sale of property are capital in nature.

Finally, at least one Tax Court decision, although involving somewhat bizarre facts and stipulations, has concluded on the basis of *Arrowsmith* that a subsequent-year gain arising from payment of a purchaser obligation (in the form of cash plus a return of the property originally sold) was capital because the payment effected an adjustment or renegotiation of the earlier underlying sales transaction. *Lowe v. Commissioner*, 44 T.C. 363, 374 (1965), *acq. in result* 1966-1 C.B. 2; see *Rabinovitz*, *supra* note 212, at 95-101. See generally *Abbott, The Reversed Transaction*, 46 B.U.L. REV. 493 (1966); *Murphy, Reacquisitions of Property*, 20 U.S. CAL. L. CENTER TAX INST. 805, 826-30 (1968). The idea that *Arrowsmith* applies to subsequent-year gains as well as losses was later reaffirmed by the Tax Court. *Bresler v. Commissioner*, 65 T.C. 182, 186 (1975) (involving section 1231 transactions), *acq. in decision* 1976-2 C.B. 1. In addition, one Tax Court judge has recently questioned, in light of the *Arrowsmith* rationale, the supposed general rule that payments subsequent to a closed sales transaction exceeding the obligation's fair market value on the date of sale constitute ordinary income. *212 Corp. v. Commissioner*, 70 T.C. 788, 809 n.11 (1978) (Fay, J., dissenting). The Service itself may recently have hammered another nail into the coffin when it ruled that a 1977 settlement of securities fraud litigation was short-term capital gain to the taxpayer because it grew out of his purchase and sale of stock in 1974. The 1974 sale resulted in short-term capital loss because the stock had been held for only four months. Under the *Arrowsmith* rule, the character of the 1974 loss determined the character of the 1977 gain, even though the corporate defendant in the securities litigation was not the purchaser of the stock sold by the taxpayer in 1974 and payment was thus less integrally connected to the underlying transaction than is the usual purchaser obligation. Rev. Rul. 79-278, 1979-37 I.R.B. 18.

In summary, there is no logical reason for distinguishing subsequent gains from subsequent losses in applying the *Arrowsmith* rationale. In addition, the area of conflict between the *Arrow-*

enough cash in the deal to pay his taxes—or he reports a lower valuation, only to find himself taxed later at ordinary income rates on a significant portion of his gain. One effect of applying section 1001 universally to isolated sale transactions—absent an installment-method election—would then be to remove one potential escape route for a cash-method taxpayer: the possibility of convincing a court that his method of accounting governs and that the purchaser obligation is not a cash equivalent. One should therefore consider whether closing this potential escape route is a serious problem and, if so, what should be done about it.

(a) *Fixed-price contracts.* At first blush, the question appears almost to answer itself. By hypothesis, we are considering an isolated transaction—that is, one not made in the regular course of a business. Because application of an accounting method makes no sense in these transactions,²¹⁷ there is certainly no basis for distinguishing cash-method taxpayers from accrual-method taxpayers. The more basic question, however, of whether either type of taxpayer should treat discount payments as ordinary income, requires deeper analysis.

At least for purchaser obligations involving a fixed face amount, the discount (the difference between face and fair market value) may be thought of as a measure of the assessed risk of nonpayment. Likewise, perceived higher risk is usually taken into account by charging a higher interest rate.²¹⁸ For example, if the interest rate on readily available and essentially riskless investments is 10%, a lender who decides, based on past experience, that there is only a fifty-fifty chance a particular class of loans will be repaid will have to charge each borrower in the class 120% interest just to match what he could make on the riskless investment.²¹⁹ If he makes a large number of loans to this class of borrowers at 120% interest and if the repayment rate follows past experi-

smith doctrine and the rule that payments on a note are ordinary income is in fact much narrower than first appears. Finally, there is only limited authority on either side of the issue in the specific fact situation giving rise to a conflict—the characterization of payments on a purchaser obligation made to the seller of property subsequent to a closed transaction under section 1001. Therefore, a judicial resolution without congressional intervention is still possible. If judicial resolution is effected, the taxpayer's dilemma discussed in the text would be eliminated, along with a strong impetus to import accounting concepts into the sale-of-property area.

217. See text accompanying notes 43-45 *supra*.

218. Professor Herwitz has made this point. D. HERWITZ, *supra* note 216, at 498.

219. Consider the simple example of a lender who has \$200. If he makes a one-year, \$100 loan to each of two borrowers at 120% interest and one of the borrowers defaults, the lender will receive one year later the \$100 principal plus \$120 in interest from the nondefaulting borrower, for a total of \$220. This total is precisely what he could have earned on his \$200 through a riskless investment at 10%.

ence, he will have a net return of 10% on the money invested in the loans. Although the lender charges a high interest rate to compensate for nonpayment of principal by others, the 120% is still an interest payment to the repaying borrower. He has in fact paid \$120 for the use of \$100 for one year. Symmetry, at least, would dictate that it also be considered interest to the lender.

In a sense, however, the argument that equates speculative risk and interest is unsatisfying. For one thing, when the lender makes a large number of loans, there is a strong argument that a large percentage of his repayment receipts truly does represent return of capital. Despite the 120% "interest" payments, he ends up with only 10% more than he started with.²²⁰ Moreover, for the taxpayer who makes an isolated speculative \$100 purchase of a debt instrument promising to pay \$220 one year later, the problem is even more complex. First, because such a taxpayer's loss on default is likely to be treated as a capital loss,²²¹ there would be some justification for permitting him a capital gain when he wins his bet and the purchaser pays. Moreover, the value of the instrument does generally vary with time in a manner that is inconsistent with the concept of a uniform interest rate. For example, it rises as the debtor maintains his job and pays his other obligations but falls with his sudden disappearance. Whether the taxpayer sells the instrument prior to maturity at a gain²²² or holds it for collection, much of his gain will be attributable to changes in circumstances prior to the sale or collection transaction in question. At high enough levels of abstraction, these changes are quite similar to the changes in circumstances that affect the values of capital assets generally. In essence, there is speculative risk in many transactions in which ultimate gain is characterized as capital.

Nevertheless, one important distinction remains. When the con-

220. Interestingly, precisely this type of lender—one in the business of regularly lending money—is usually indifferent to the characterization of the repayments. Any defaulted loans will constitute business bad debt deductions from his ordinary interest income. § 166(a).

221. The nonbusiness bad debt deduction is limited to short-term capital loss treatment. § 166(d). Moreover, in the case of default on a purchaser obligation received in an isolated sale-of-property transaction, the *Arrowsmith* rationale will usually serve independently to limit any deduction to capital loss. See note 216 *supra*.

222. A sale prior to maturity will apparently be treated as a sale or exchange for capital gain purposes unless it is considered a sham. The sale will be good if there is a bona fide passage of title and risk but not if the purchaser acts simply as a conduit for redemption or repayment. Compare *Everett v. Commissioner*, 4 T.C.M. (CCH) 454, 455 (1945), and *Hobby v. Commissioner*, 2 T.C. 980, 985 (1943), *acq.* 1944-1 C.B. 13 (both finding bona fide sales, for long-term capital gain purposes, of stock a few days prior to redemption), with *Weimer v. Commissioner*, 316 F.2d 473, 473 (3d Cir. 1963), and *Hilton v. Commissioner*, 13 T.C. 623, 630-31 (1949), *acq.* 1950-1 C.B. 3 (both finding that the purchaser acted as a conduit).

tingency creating the discount relates only to whether the purchaser will fulfill his legal obligation, as is usually the case in a fixed-price contract, the discount payments might be more appropriately considered interest, because this risk is traditionally associated with a higher interest rate. Banks, for example, do not lend to everyone at the prime rate. On the other hand, if the amount the seller will receive may vary even when the purchaser satisfies his obligations in full, the change in value is similar to what is traditionally characterized as a capital gain.

Resolution of this characterization problem would require analysis of the sale-or-exchange requirement for the capital gain preference; such an analysis, however, is beyond the scope of this Article. Nevertheless, given that the sale-or-exchange requirement is a correct interpretation of the statute and that repayment of an obligation does not generally satisfy it, there is yet another example that makes treatment of the discount payment as ordinary income more palatable. If a taxpayer acquires a third-party debt instrument due in one year in the face amount of \$100 plus 120% stated interest, there is little if any authority that does not hold him to the form of the instrument he chose to deal in. He has ordinary interest income on payment. If instead the same taxpayer acquires a one-year obligation with a \$200 face amount and stated interest of 10%, but he pays the same \$100 for it because of the risk he perceives, there is little justification for a different treatment of the discount payment. Accordingly, it is hard to see why a discount in the assessed value of a purchaser obligation received in an isolated property sale transaction based on such factors as probability of repayment, amount of collateral, and degree of stated interest should be treated any differently than a third-party obligation.²²³

In summary, we can say that giving cash-method taxpayers the equivalent of open-transaction treatment by applying their accounting method to isolated sales of property is at best haphazard. There is simply too much variation in the judicial approaches to accommodating the accounting provisions with section 1001. In addition, there is no basis for singling out cash-method taxpayers for favored treatment in the case of isolated sales. Finally, for either type of taxpayer, treating discount payments after a closed sale-of-property transaction as ordinary income is consistent with the notion that risk of default is a measure of interest income.

223. In either case, the taxpayer has purchased the obligation in question, in one case for cash and in the other for property. See D. HERWITZ, *supra* note 216, at 503. Of course, this entire discussion assumes that the *Arrowsmith* rationale will not be applied to payments on purchaser obligations in years subsequent to a closed transaction. *Arrowsmith* arguably could supply the necessary sale or exchange for discount payments on a purchaser obligation. See note 216 *supra*.

An additional observation is probably even more important: when the purchaser obligation involves a fixed face amount, the transaction can usually be structured to permit reporting of gain under the installment method of section 453. Proper structuring of the sale thus permits the seller to claim any capital gain preference otherwise available for the full amount of the discount. For fixed-price purchaser obligations, then, treatment of the discount payments as ordinary income following a closed transaction does not raise a fundamental problem with the suggested interpretation of the statute.

(b) *Contingent-price contracts.* Obligations for contingent amounts present problems that are not so easily resolved. These obligations often arise, for example, when mineral rights are sold to a developer for a percentage of ultimate revenues derived from the property or when a nonpatentable invention or secret process is sold for a percentage of ultimate sales to a firm better equipped than the inventor to develop and market it.²²⁴ In many, if not all, of these cases, the obligations can be reasonably valued as of the date of sale.²²⁵ In some cases, such as the sale of mineral rights, there may even be an actual market in the sense that arm's-length bids are available. Nevertheless, one or both of the parties may be unwilling to assume the risk of being wrong in the assessment of value, and such unwillingness is often expressed in a percentage-of-sales or similar contingent-price contract. Assuming these transactions are treated as closed under section 1001 because the purchaser obligation has an ascertainable fair market value, two questions arise. First, should amounts received on the obligation beyond such fair market value be treated as ordinary income? Second, can such treatment be justified or are there more attractive alternatives?

Again, an example makes the issues more concrete. Suppose a taxpayer owns the mineral rights to property on which there is one chance in ten of finding oil. For simplicity, assume he has a zero basis in these rights. Drilling costs, including a normal return, are \$25,000 regardless of whether oil is discovered. If oil is discovered, the mineral rights are expected to produce a stream of revenue having a present value of \$500,000. If no oil is found, the rights will be valueless. In these circumstances a rational oil driller in a competitive market will bid up to \$25,000 for the rights. Thus, the fair market value of the rights may be set at \$25,000. If the taxpayer sells for this price, he has a straightforward gain of \$25,000, and the driller risks losing a full

224. Inventors holding patents can usually arrange their transfers in such a way that the sale or exchange necessary for capital gain treatment is supplied by statute. § 1235.

225. See text accompanying note 203 *supra*.

\$50,000 in order to have the opportunity for a possible bonanza profit of \$450,000.

The taxpayer may, however, prefer to gamble that oil will be discovered and participate in the bonanza, or the driller may prefer to risk only the drilling costs. Taxpayer and driller might then agree that the rights will be conveyed for a straight fifty-fifty split of revenue from any oil discovered. How much the taxpayer will ever receive on this contract is highly uncertain: he may eventually get \$250,000 in present value, or he may get nothing. Nevertheless, it seems clear that the value of this purchaser obligation is neither zero nor unascertainable; in fact, it is \$25,000.²²⁶ Therefore, assuming the mineral rights are a capital asset in taxpayer's hands, if the transaction is treated as closed under section 1001, taxpayer has a capital gain of \$25,000 in the year of sale.²²⁷ In subsequent years, he will have either an additional \$225,000 of ordinary income or, if the driller finds nothing, a \$25,000 capital loss.²²⁸

The question is whether a closed-transaction approach to section

226. In an arm's-length transaction, it is usually held that the value of property received, when that value is difficult to measure intrinsically, can be equated to the value of the property given in exchange. *E.g.*, *United States v. Davis*, 370 U.S. 65, 72 (1962); *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1934). In the hypothetical, the mineral rights are clearly worth \$25,000 in a competitive market. Therefore, the value of the contract taken in exchange for rights in an arm's-length transaction can be assumed to be \$25,000 as well. Moreover, one need not, under the assumed facts, adopt this valuation by association approach. Under his percentage contract, our taxpayer has one chance in 10 of receiving \$250,000 (in present value) and nine chances in 10 of receiving nothing. Anyone in the business of buying up these contracts would lose money in the long run if he paid more than \$25,000 for any single one. In a competitive market, however, he could not get away with paying less. Therefore, the contract has a value of \$25,000.

227. Depending on how the transaction is structured, income to the extent of half of the drilling costs may be imputed to the taxpayer; he clearly receives half the benefit from these costs. The example attempts, however, to focus on certain concepts; it does not purport to portray anything realistic and certainly nothing in any way tied to oil discovery. Therefore, to keep things simple and as independent as possible from the arcane world of real life oil and mineral exploration, we ignore the possibility of drilling-cost income to the seller. Presumably, if he has this income he will also have a deduction sooner or later in the same amount.

228. One can obtain a slightly more realistic version of the problem, without changing the result of the analysis, by relaxing the assumption of a precisely known probability of discovery and a known present value of future income flow in the event of discovery. In this case, both parties will have to make estimates of these quantities, and their conclusions will affect both the cash sale price of the mineral rights and the respective percentage interests in any contingent-price contract. The amount that the taxpayer will eventually receive under a percentage contract will not be determined on an all-or-nothing basis, but will vary from zero to a somewhat nebulous upper limit. The precise value of both the mineral rights and taxpayer's contingent-price contract will be much less clear, but a rational estimate of that value can often still be made. In fact, mineral rights are bought and sold every day, and certainly those in the business of oil exploration put a great deal of effort into assessing the chances of actually making a discovery and the value of the oil if discovered.

1001 that makes no reference to the taxpayer's method of accounting is a rational and equitable approach to taxation of contingent-price sales contracts that can be reasonably valued.²²⁹ It might be observed that the discrimination between accrual-method and cash-method taxpayers that results from applying the accounting provisions in lieu of section 1001 to fixed-price contracts does not exist in the case of most contingent-price contracts. If accounting methods governed, a cash-method taxpayer would simply report the receipts as they came in, but because the total amount of the contract cannot be determined with reasonable accuracy, an accrual-method taxpayer would presumably do the same thing.²³⁰

Moreover, the argument equating the discount to risk of default,²³¹ whatever its merits with respect to fixed-price contracts,²³² is much weaker here. This weakness does not arise out of formal problems in defining the amount of the discount. Admittedly, there is no fixed face amount of the contract from which the total discount can be calculated, but any amount eventually received above the previously reported fair market value—which is the taxpayer's basis in the contract—must be included in income. The issue is only the character of this income. Nor does the weakness come from certainty of payment. In fact, the discount exists precisely because, on our assumed facts, nine times out of ten the seller will receive nothing on the contract. Rather, the weakness seems to inhere primarily in the feeling that, under the contingent-price contract, the taxpayer has maintained a fundamental equity interest in the property. That is, the risk is not whether the purchaser will perform his obligations but instead arises from the seller's lack of knowledge as to the existence of oil. If he invested the \$25,000 drilling costs himself, he would then know whether his mineral rights were worthless or worth \$500,000. If the latter, no one doubts that he could then sell the rights on a high, fixed-priced contract and treat the gain as capital. When he sells the rights on a contingent-price contract, he splits the risk, but in an economic sense he nevertheless pays \$25,000 to

229. Nothing in the suggested approach to section 1001 prohibits open-transaction treatment if one concludes that the contract cannot reasonably be valued. However, if ascertainability of value and not the mere fact of contingency is really the test, there may not be many contingent-price contracts that qualify. See notes 198-203 *supra* and accompanying text.

230. Treas. Reg. § 1.446-1(c)(1)(ii) (1979). When a particular receipt actually comes in, the right to receive it is already fixed and its particular amount is fully determined. Therefore, the receipt is includable in income of an accrual-method taxpayer at that time. Conceivably, at some point near the end of the productive life of the well, the remaining amount to be received by an accrual-method taxpayer may become determinable with reasonable accuracy. To this extent, his reporting of income could differ from that of a cash-method taxpayer.

231. The discount might be treated as interest income if it is equated with risk of default.

232. See text accompanying notes 218-23 *supra*.

participate in the half interest that he retains.²³³ Thus, the ultimate payoff in the happy event of oil discovery is more like a redemption of an equity participation than a loan repayment, and it is difficult to treat the discount as ordinary income on the ground that it is equivalent to interest on a debt.

Nevertheless, terms like "equity interest" are of little value for determining whether the discount payments should receive capital gain treatment. We are again forced back to the fundamental recognition that current law requires a sale-or-exchange element for the capital gain preference.²³⁴ If one accepts that requirement and the proposition that payment of an obligation does not generally satisfy it, a third party who acquires a contingent-price contract by cash purchase will necessarily have ordinary income from payments on the contract that exceed his basis. The question is whether it makes sense to try to distinguish this third party's tax situation from that of a taxpayer who sells his own property for a contingent-price contract. Moreover, if the distinction makes sense, we must find a doctrinal basis for it.

At the root of the matter we find a taxpayer owning a capital asset, the mineral rights, that he wishes to sell. Unfortunately, however, he does not know their true value, as opposed to their fair market value for purposes of section 1001, and section 1001 makes him pay a heavy tax penalty for this lack of knowledge regardless of the drilling results. If the drilling is unsuccessful, he has paid tax on a \$25,000 long-term capital gain without ever receiving anything from the sale, either at the time of the transaction or later. The only relief is in the form of a future capital loss, which he cannot even carry back to offset his earlier gain.²³⁵ If the drilling is successful, it means the rights were actually worth much more than he reported earlier, but his capital gain is limited to the earlier-reported figure. On the other hand, the third-party

233. Ignoring taxes that the seller would pay if he sold the rights for cash, he could receive \$25,000 for them. He foregoes this receipt in order to participate in the venture, and he will never recover it should the mineral rights prove worthless. Similarly, if he chooses to handle the drilling himself, he pays \$50,000 for the privilege of maintaining a 100% participation in the venture.

234. If this taxpayer, for example, sold an undivided one-half interest in the mineral rights for the purchaser's promise to carry out the drilling, he should report income in the amount of \$12,500—the value of the promise. He may also have a later deduction in this amount. All income from his share in the proceeds from oil sales would be ordinary gain, because notwithstanding his equity interest, he is now in the business of producing and selling oil. In order to get capital gain treatment, he must effect a second sale of his remaining one-half interest in the rights after oil is discovered. Nevertheless, either of these taxpayers, seller or purchaser, can get the same result by selling his one-half interest after discovery. Therefore, the issue of how the seller's gain in our original hypothetical should be characterized when he does not resell his contract cannot be resolved by looking to such factors as equity interests.

235. See the second paragraph of note 182 *supra*.

taxpayer who purchases the contingent-price contract consciously chooses to place himself in a situation in which his fortunes will vary dramatically with developments in future knowledge. The tax consequences, whatever they are, are matters that he can take into account in deciding whether to make the investment. If the two taxpayers are to be distinguished, therefore, it must be on the basis that one has sold an underlying capital asset of highly uncertain true value, whereas the other has not.²³⁶ The next question is how the necessary sale-or-exchange element is to be supplied.

(c) *Possible doctrinal bases for capital gain treatment of discount payments under contingent-price contracts.* If the seller of capital-asset property under a contingent-price contract is to have capital gain on payments received subsequent to his including the contract's fair market value in the amount realized under section 1001, it will be necessary to reconsider firmly established judicial doctrine. Perhaps with the help of the *Arrowsmith* rule we could modify the doctrine that payments on an obligation following a closed transaction do not involve a sale or exchange. An alternative approach is to continue using some form of the open-transaction doctrine, preferably with a more rational and predictable basis. In any case, because a decision in favor of capital gain treatment would presumably be designed to ameliorate the quandary in which current law places the seller of capital-asset property whose true value is highly uncertain, neither approach should be adopted without considering its interrelationship with the installment sale provisions.

(i) *Application of the Arrowsmith rule.* The application of the *Arrowsmith* holding to relate the earlier sale to discount payments and thereby make them eligible for capital gain treatment, if adopted, must logically be extended to fixed-price as well as to contingent-price contracts. In *Arrowsmith* the Court held that notwithstanding the absence of a sale or exchange in a subsequent year, a subsequent-year payment (or, arguably, receipt) by a taxpayer will be treated as capital if it is integrally related to a capital transaction in a prior year.²³⁷ In the cases

236. It is immediately evident that this distinction will often exalt form over substance. For example, our second taxpayer might just as consciously enter this speculative investment by purchasing the actual mineral rights for a flat \$25,000, assuming they or their equivalent are available. He is then indistinguishable from the first taxpayer, but his claim to special tax treatment seems no greater than it was before. Again, any attempt at fundamental resolution of this problem must get into the sale-or-exchange requirement itself, but that analysis is beyond the scope of this Article.

237. See notes 213-16 *supra* and accompanying text.

we are considering, the prior-year transaction is the original sale of a capital asset. In the usual contingent-price contract, however, the seller parts with considerably less than he does in a fixed-price contract; the amount the seller will receive usually depends on the future success of the venture in which the property is used, and in a very real sense the seller maintains an equity interest in the property sold. Therefore, the underlying transaction in the contingent-price case is less like a sale than in the fixed-price case,²³⁸ and in this sense the discount payments look a bit like payments from a partnership engaged in the development of the property.²³⁹ Thus, if the *Arrowsmith* rule applies to payments on contingent-price contracts, the rule should also apply to fixed-price contracts, in which the transaction is more clearly an outright sale.

Admittedly, once it is granted that a sale has taken place,²⁴⁰ the contingent-price discount payments are arguably more like a true payment of the purchase price than are fixed-price discount payments. Nevertheless, this is a weak ground for distinction. In fixed-price contracts the entire discount is closely associated with factors usually treated as interest. In contingent-price contracts, however, the discount depends on two types of risk: first, risk of nonpayment dependent on the characteristics of the purchaser and the transaction; second, risk of nonpayment dependent on other future developments. Only the second type of risk, typical of capital gain assets, makes subsequent payments on the contract seem similar to payments of the purchase price. To distinguish, in the application of *Arrowsmith*, fixed-price from contingent-price contracts on this ground would logically require a quantitative assessment of each of the two types of risk in contingent-price contracts. This may be an even more difficult task than the original valuation process.

In conclusion, it is difficult to see how the fact of price contingency

238. Courts typically look to such factors as the degree of risk retained by the seller and the existence of a fixed sale price to determine both the timing of a sale and whether a sale has in fact occurred. *E.g.*, *Bradford v. United States*, 444 F.2d 1133, 1144 (Ct. Cl. 1971); *Maher v. Commissioner*, 55 T.C. 441, 451-52 (1970), *aff'd*, 56 T.C. 763 (1971), *nonacq.* 1977-2 C.B. 2, *aff'd in part and rev'd in part on other grounds*, 469 F.2d 225 (8th Cir. 1972); *Consolidated Gas & Equip. Co. of America v. Commissioner*, 35 T.C. 675, 682 (1961).

239. See notes 233-34 *supra* and accompanying text.

240. It may be observed that the application of section 1001 to the underlying transaction, as is assumed here, does not require that a sale or exchange for capital gain purposes has taken place. Section 1001 applies to all "sale[s] or other dispositi[on]s," and a transfer of property in exchange for a contingent-price contract conceivably is a rearrangement of interests sufficient to constitute a disposition under section 1001. This transaction, however, might not qualify as a sale or exchange for capital gain purposes. In that case, the entire underlying transaction, not just the discount, should involve ordinary gain or loss.

makes the actual payment any more integrally related to the underlying sales transaction than a fixed payment would be. Consequently, if the *Arrowsmith* rationale is to be used to characterize the discount payments, it should be applied to fixed- as well as contingent-price contracts. If nothing else, adopting this approach would simplify enormously the problems associated with taxing the sale of property.

(ii) *Distinguishing fixed- from contingent-price contracts through a modified open-transaction approach.* If capital gain treatment must be limited to discount payments made on contingent-price contracts, one way to achieve doctrinal coherence would be to modify the open-transaction approach. The modified approach would be based on the fact of contingency rather than on the absence of an ascertainable market value: Any sale-of-property transaction involving a purchaser obligation that the Service holds ineligible for installment reporting under section 453 on the ground of a contingency in price or obligation to pay should be regarded as open for the purposes of applying section 1001. Thus, when the installment method is unavailable because of contingencies, the transaction would be entitled to open-transaction treatment.

This modification of the open-transaction doctrine would be a definite improvement on the current approach. The open-transaction doctrine based on ascertainability of fair market value of a purchaser obligation, with its emphasis on the value of the obligation, operates haphazardly at best. Especially with the burden of proof on the taxpayer, one can never be certain he has met the requirements, and this makes careful tax planning extremely difficult.²⁴¹ In addition, the modified approach would not require any radical change of doctrine. It simply would involve recognizing that the economic rationale for approving open-transaction treatment has been a contingency, other than the purchaser's failure to fulfill his legal obligations, that might cause a significant future change in the value of the obligation.²⁴²

Even more important, however, is that ascertainability of value for the purchaser obligation bears no rational relationship to the principal

241. See notes 60 & 146 *supra* and accompanying text.

242. Price contingency of the classic *Burnet v. Logan* type need not be the sole ground for open-transaction treatment, although that type has inspired the use of the term "contingent-price contract" and serves as a model for the discussion in the text. The right to a specific amount may be sufficiently contingent to justify open-transaction treatment. *Cf. In re Steen*, 509 F.2d 1398, 1403 (9th Cir. 1975) (right to payment dependent on favorable judicial decision on a novel question of state law); *Bolles v. Commissioner*, 69 T.C. 342, 355-56 (1977) (right to additional consideration on sale of stock dependent on purchaser's success in acquiring at least 50% of the outstanding shares through a tender offer).

problem in characterizing discount payments on contingent-price contracts.²⁴³ The real problem with contingent-price contracts is that their value on the date of the sale, even when that value can quite rationally and definitively be ascertained, will often be very different from what later turns out to be their true value. Severe tax penalties may attach to any error in valuation made as of the date of sale. In a sense, then, the real problem is not whether the value is ascertainable but whether the ascertained value is *fair*. Thus, if the Service denies installment treatment because of a price contingency, the courts should allow open-transaction treatment on the ground that no fair market value is ascertainable.

(iii) *Interrelationship with the installment method of reporting.* Because of the close relationship between the suggested modification of the open-transaction doctrine and the installment method of reporting, a brief review of the current treatment of contingent-price contracts under section 453 is helpful in assessing this modified approach to open transactions. Under current law, there is no clearly available installment method of reporting gain in cases involving a contingent-price purchaser obligation. The basic purpose of section 453, however, is to reduce the hardship of taxing the full section 1001 profit from a sale when the taxpayer may have received little or nothing in the year of sale with which to pay his tax.²⁴⁴ If no installment election were available to delay recognition of gain and to preserve the character of the underlying sale, much could undoubtedly be said for a judicial ap-

243. A good example of the reasons why ascertainability of value should not be the test of openness for the purpose of treating the discount payments as capital gain is the confusion that test caused recently in *McCormac v. Commissioner*, 67 T.C. 955 (1977). In *McCormac* taxpayers received on a section 333 liquidation a right to payments from a trust fund consisting of prepaid funeral expenses. The Service treated the payments as ordinary income because of the absence of a sale or exchange—that is, on the ground that the section 333 liquidation was a closed transaction. Taxpayers argued that the transaction should remain open because the right had no ascertainable fair market value, even though fair market value is irrelevant to taxation of the section 333 liquidation transaction. The Tax Court rejected the argument but only on the ground that taxpayers failed to prove the absence of ascertainability. *Id.* at 964. Surely the important distinction between ordinary income and capital gain should stand on something less ephemeral than whether a right to payment had an ascertainable fair market value in a prior proceeding in which the fair market value was neither ascertained nor required to be ascertained.

244. *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 503 (1948); *Dennis v. Commissioner*, 473 F.2d 274, 284 (5th Cir. 1973); *Tombari v. Commissioner*, 299 F.2d 889, 891 (9th Cir. 1962); *Horneff v. Commissioner*, 50 T.C. 63, 75 (1968) (Tannenwald, J., dissenting), *vacated and remanded*, 1969-2 U.S. Tax Cas. ¶ 9727 (3d Cir. 1969); *Irwin v. Commissioner*, 45 T.C. 544, 550 (1966), *rev'd on other grounds*, 390 F.2d 91 (5th Cir. 1968); *cf.* H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934) (Congress finds it unreasonable to use installment method of reporting income to postpone paying taxes “in cases where such tax can well be paid in the year of the sale”), *reprinted in* 1939-1 C.B. (pt. 2) 554, 572.

proach that tempered the rigors of section 1001, notwithstanding conflicts with statutory language or apparent legislative intent. In the case of fixed-price contracts, however, section 453 usually stands ready to ease the burden on any taxpayer who is careful enough to bring himself within its requirements.²⁴⁵ Because the statutory scheme contains a safety valve to relieve the pressure, there is less justification for judicial tampering.²⁴⁶

Contingent-price purchaser obligations, in which the underlying sale involves a capital asset, present a stronger case for treating at least a part of the discount payments as capital gain,²⁴⁷ but current law disqualifies these contracts from installment sale treatment. The disqualification stems from a somewhat formal reading of section 453, which treats as income that portion of any payment received on the contract, including the downpayment, that equals the ratio of the gross profit to the total contract price.²⁴⁸ In a contingent-price contract, neither the gross profit nor the total contract price is known in the year of the sale. Thus, the percentage of each payment that must be included in income cannot be precisely determined, and courts ruling on the issue have upheld the Service in holding that section 453 is unavailable in these cases.²⁴⁹ Coherent interpretation of section 1001 and section 453, however, suggests that these decisions are wrong.

A general principle of tax law is that privileges and exemptive provisions should be strictly construed.²⁵⁰ Although section 453 is a relief

245. Section 453 is no model of perfection even in the case of fixed-price contracts. In fact, the statute and its interpretation have been subject to severe and cogent criticism. *E.g.*, Ginsburg. See also text accompanying notes 295-307 *infra*. However, because most fixed-price transactions can be structured to qualify for the section 453 election, the harshness otherwise resulting from section 1001 can be avoided, and any remaining problems are more appropriately addressed directly rather than through a distorted interpretation of section 1001.

246. The Ninth Circuit has also concluded, although without distinguishing between regular and isolated sales, that when section 1001 would otherwise apply, the installment sale provisions of section 453 stand as the sole basis for relief. *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 792 (9th Cir. 1975). See also *In re Steen*, 509 F.2d 1398, 1404 (9th Cir. 1975).

247. See notes 229-36 *supra* and accompanying text.

248. Basically, the gross profit is the selling price, including assumed mortgages, minus the seller's basis. The total contract price is the selling price minus assumed mortgages. See *Treas. Reg. § 1.453-4(c)* (1958); Miller, *Installment Sales of Mortgaged Realty—Another View*, 6 J. REAL EST. TAX. 5, 11-12 (1978). If the amount of the mortgage exceeds the seller's basis, the excess is included in the total contract price. This insures that the ratio of gross profit to total contract price will not be greater than one.

249. *Gralapp v. United States*, 458 F.2d 1158, 1160 (10th Cir. 1972). See also Emory, *The Installment Method of Reporting Income*, 53 CORNELL L. REV. 181, 195-96 (1968).

250. *E.g.*, *Cappel House Furnishing Co. v. United States*, 244 F.2d 525, 529 (6th Cir. 1957). See also *Baltimore Baseball Club, Inc. v. United States*, 481 F.2d 1283, 1285 (Ct. Cl. 1973) (applying the principle of strict interpretation to uphold the Service's two-payment rule under section 453).

provision, however, there is good reason not to apply this principle to it blindly. If the seller has clearly received less than 30% of the selling price in the year of the sale, as is often the case when there is a fixed minimum price plus a contingency, he fits within the class of taxpayers whom the statute was designed to relieve: those who have not received sufficient cash with which to pay their taxes.²⁵¹ Moreover, section 453 gives the Service broad authority to write regulations providing for the return of income pursuant to its installment method.²⁵² Professor Ginsburg has suggested a number of possibilities,²⁵³ all of which are consistent with the statute,²⁵⁴ for handling contingent-price contracts under

251. See note 244 *supra* and accompanying text.

252. § 453(a)(1), (b)(1).

253. Ginsburg 493-97. For example, if there is a maximum price, the government does not lose if that maximum is taken as the total contract price for the purpose of calculating the percentages; if the maximum is not reached, the taxpayer will later have a capital loss. If there is a fixed time period for payments, basis can be apportioned ratably over the period, with any excess in a particular period treated as gain. Even if there is neither a maximum price nor a fixed period of payment, the regulations could simply fix a reasonable period for recovery of basis—perhaps the seller's life expectancy or, in a particular case, an expected period of production of the asset sold. In fact, at the 1979 hearings on legislation proposed to simplify installment reporting, the Treasury Department appeared to approve this approach, at least in principle. Treas. Release No. B-1758, at 9-14.

Moreover, in many cases the seller's basis may be so low compared to expected receipts on the contract that nearly all of each payment will represent gain no matter how the percentage is calculated. This situation arose in both *In re Steen*, 509 F.2d 1398 (9th Cir. 1975), and *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972). In such cases the government can hardly complain about administrative difficulties or delayed payment of taxes if the taxpayer offers to report all of each payment as gain under section 453, recovering his basis in the year that the final payment is made, or taking a loss when it becomes clear that no more payments will be forthcoming. When there is a sizable fixed minimum payment, as there was in both *Steen* and *Gralapp*, this approach might not constitute too high a price for avoiding immediate taxation to the extent of fair market value of the fixed obligation, obtaining capital gain treatment for the discount payments on the fixed obligation, and obviating the need to argue about whether the contingent portion could be valued. Although apparently neither taxpayer in these cases offered to report in this manner, one or the other may well have done so if the procedure had been authorized by regulation.

To the Service's credit, it has tried to provide for a ratable reporting of gain in the very limited area of private annuities received in exchange for appreciated property. The Service, however, has been rebuffed in this attempt by the Tax Court. See note 74 *supra*.

A more difficult problem in the case of contingent-price contracts may be defining the statutory 30% requirement. That problem, however, also appears solvable by regulation. See notes 300-01 *infra* and accompanying text.

254. Section 453(b) states that income from sales of real property and casual sales of personal property "may (under regulations prescribed by the Secretary) be returned on the basis and in the manner prescribed in subsection (a)." Section 453(a) expressly sets forth the installment method with respect to dealings in personal property and requires that each payment received on the contract be included in income in the ratio of the gross profit to the total contract price. See note 248 *supra*. Neither gross profit nor total contract price is defined by the statute, at least for the purpose of section 453(b) sales. A very narrow reading of the section would be that the Service is unauthorized to extend its benefits to contingent-price contracts on the ground that the term "total contract price" implies a fixed number. Consequently, an amendment of section 453(b) expressly

an installment approach. The Service could adopt these procedures by regulation, and no additional input from Congress would be required. There is no need for highly technical construction when the underlying policies are clear and a rational method of resolving individual cases is available.

In summary, then, a test relying on the ascertainability of the market value of contingent-price purchaser obligations does not rationally distinguish between sellers of property who are and those who are not equitably entitled to capital transaction characterization for their discount payments. Moreover, while an argument can be made that the discount payments should represent ordinary income on all purchaser obligations, the fact is that we permit capital gain treatment of the discount on fixed-price purchaser obligations through the availability of the installment sale provisions, even though as between fixed- and contingent-price contracts, the latter have the greater equitable claim to this benefit. In many cases involving taxation, the best one can do is point out the anomaly and call for statutory reform, but that is not the case here. Any court that sees the issue in its correct perspective can fashion a satisfactory solution within the current statutory framework. The court would reason that when section 1001 would otherwise apply, the purpose of section 453 is to give some tax relief to sellers of property in isolated transactions who do not receive enough cash in the year of sale to cover their tax. Accordingly, these sellers should be able to pay their tax pro rata out of each payment received. The Service is broadly authorized to write regulations specifying the method of installment reporting and is capable of writing reasonable regulations covering contingent-price purchaser obligations. Therefore, if the Service holds that a particular transaction involves a contingency rendering section 453 unavailable, it is appropriate for the court to take the view that no fair market value can be ascertained. The reason for the absence of a fair market value, however, is not that the obligation has no value, but that the future value is likely to be very different from the current value even when the purchaser fulfills all of his obligations under the contract. Doctrinally, this would simply be a continuation of the time-honored open-transaction approach. The test, however, would bear a more rational relation to equitable taxation and statutory

permitting installment reporting on contingent obligations might be useful. This proposal is currently under consideration. See notes 277-82 *infra* and accompanying text.

Such a narrow reading of the Service's authority, however, is hardly necessary. Because the statute does not define the relevant terms, the broad authority to adopt regulations should certainly include authority to make rational definitions of gross profit and total contract price when contingencies are present. Moreover, because section 453 is ameliorative and optional, it might be difficult to find a person with standing to complain about the regulations.

interpretation.

Judicial application of the suggested test would be very simple. The only inquiry would be whether, under current regulations, installment-method reporting under section 453 was unavailable on the ground of contingencies in the purchaser obligation. It will usually be quite clear whether this test is satisfied, since litigation will not normally arise unless the taxpayer has attempted to make a section 453 election and has been denied by the Service.²⁵⁵ The test would certainly be more predictable in result than the almost metaphysical current test of whether the purchaser obligation has an ascertainable value. It would reserve open-transaction treatment, for which there is little statutory authority,²⁵⁶ for those who are denied the benefits of section 453 for reasons that have no relationship to the taxpayers' ability to pay the tax from the transaction.²⁵⁷ On the other hand, those ineligible for open-transaction reporting would, by hypothesis, either

255. The regulations require that the elections be made in the return covering the tax year of the sale. Treas. Reg. § 1.453-8(b)(1) (1958). Therefore, failure to make the election would be a ground for denying open-transaction treatment under the test suggested, as ineligibility for section 453 reporting would rest not on the contingency but on the failure to make a timely election. At the least, the taxpayer who believes he does not qualify should claim open-transaction treatment on the ground of the contingency but elect the installment method in the alternative. This approach appears to be acceptable to the courts. See *Warren Jones Co. v. Commissioner*, 254 F.2d 788, 789, 794 (9th Cir. 1975). If the Service denied both, the issue would be clear in subsequent litigation.

256. See text accompanying notes 97-101 *supra*.

257. The facts in *In re Stecn*, 509 F.2d 1398 (9th Cir. 1975), and *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972), are instructive. Both cases involved the sale of mineral rights by extremely low-basis sellers for a significant fixed minimum price, to be paid in installments, plus a contingency. In both cases the courts concluded that the contingent portion of the purchaser obligation was to be held open on the ground that it was not capable of valuation. Consequently, the government would not collect tax on that portion of the gain until and unless it was paid. However, the existence of the contingency was enough to make the total contract price unascertainable, and both courts thought that section 453 should therefore be unavailable even for the fixed-price portion. In other words, the result in both cases was to adopt a wait and see approach with respect to the contingency, so that the only issue remaining for decision was whether basis could be recovered and profit reported ratably out of actual payments on the fixed portion, or whether section 1001 alone would apply.

Once the courts took the contingency out of the picture, there could be no justification for its serving as the reason to deny an installment election otherwise available. Section 453 gives every fixed-price property seller the right to elect, and the possibility that these particular taxpayers might receive some additional payments at the end of the contract period should not make any difference as to section 453 eligibility. Basis would have been recovered by that time in either event, and additional payments would represent income in their entirety. Taxation of the contingency payments is exactly the same whether or not section 453 treatment is allowed.

A much more sensible approach in both cases would have been to permit the adoption of section 453 with respect to the fixed-price portion and to follow the open-transaction approach with respect to the contingency. This approach will serve well enough until the Service promulgates regulations permitting installment reporting of contingent-price contracts. The same approach should be taken even if the contingent-price portion of the contract has an ascertainable

have section 453 to relieve the harshness of section 1001 or would in any event be ineligible for reasons that Congress has expressly decided are sufficient to require the application of section 1001. Finally, in the long run, the modified test would probably spell the end of the open-transaction approach, as the Service would have a strong incentive to devise regulations expanding the coverage of section 453 to contingent-price contracts.²⁵⁸ Section 1001 and section 453 would then be the sole either/or choice available to taxpayers who make isolated sales of property, and nearly all of the judicial verbiage that has developed around these statutes over the past fifty years could be forgotten.

(iv) *Currently proposed legislative changes.* In 1979, legislation designed to simplify reporting income pursuant to the section 453 installment method was introduced jointly in the House²⁵⁹ and Senate.²⁶⁰ The bills as introduced would eliminate two eligibility rules under section 453: the requirement that no more than 30% of the selling price be received in the year of sale, and the administratively adopted rule that two or more payments in two or more tax years are necessary for the election of installment reporting. Both of these changes would be welcome.²⁶¹ However, in its descriptions of the bills, the Joint Committee on Taxation brought up additional issues for consideration, including sales subject to a contingency and the open-transaction problem.²⁶² In the hearings before the House Ways and Means Committee, the Treasury Department indicated that it would support the proposed eligibility changes provided that the sponsors include additional amendments to section 453 that, in practical effect, would require all casual sales of

value in the year of sale. That portion, but not the fixed-price portion, should be treated as open unless and until the Service agrees to its eligibility for the installment method of reporting.

258. It would certainly remove the basis for open-transaction treatment of most, if not all, third-party obligations received upon a sale or exchange. Because section 453 is not available for these obligations, the open-transaction approach should not be available either. The only exception would be the rare case in which the third-party obligation has a value but that value is for some reason truly not ascertainable. Nothing suggested in this Article would prohibit an open-transaction approach in cases of true nonascertainability; there is, however, a question as to how many of these cases actually exist. See text accompanying notes 197-203 *supra*.

259. H.R. 3899, 96th Cong., 1st Sess. (1979).

260. S. 1063, 96th Cong., 1st Sess. (1979).

261. See text accompanying notes 295-307 *infra*.

262. STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., DESCRIPTION OF S. 1062 AND S. 1063 RELATING TO SIMPLIFICATION OF CERTAIN PROCEDURE AND ADMINISTRATION PROVISIONS AND INSTALLMENT SALE REPORTING RULES UNDER THE INTERNAL REVENUE CODE 29-31 (Joint Comm. Print 1979); STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., DESCRIPTION OF H.R. 3899 AND H.R. 3900 RELATING TO SIMPLIFICATION OF INSTALLMENT SALE REPORTING RULES AND CERTAIN PROCEDURE AND ADMINISTRATION PROVISIONS UNDER THE INTERNAL REVENUE CODE 16-18 (Joint Comm. Print 1979).

property to be reported on the installment method.²⁶³

The key to the Treasury proposal is the allocation of basis over the period in which payments are to be made. The proposal, applying to all sales of real property and casual sales of personal property, would permit the taxpayer to elect to include the fair market value of the purchaser obligation in income for the year of sale. Unless the fair market value of the purchaser obligation were equal to its face value and there were no contingent payments, however, part of the taxpayer's original basis in the property he sold would be attributable to payments received in later years. Thus, the taxpayer would not be able to deduct his full basis from the fair market value of the obligation in determining his gain, and the total income reported in the year of sale would be even greater under the election than under current section 1001. There is, therefore, a strong disincentive to making the election. Moreover, if the purchaser obligation has no ascertainable fair market value, the results under the election would be identical to those from the new installment method. The character of the gain in either case (including the discount payments) would be the same for all payments.²⁶⁴ Because all sales would automatically be under the new installment method unless election were made to include the fair market value of the purchaser obligation in the first year, the cost-recovery, or open-transaction, method would be denied.²⁶⁵

Making all purchaser obligations, whether contingent or not, eligible for installment reporting would certainly be a welcome change, although it is doubtful that rewriting the statute is necessary to do it. Moreover, treating all discount payments as satisfying the sale-or-exchange requirement for capital gain treatment would eliminate the current illogical distinction between the purchaser obligation of a corporation and that of an individual.²⁶⁶ However, the Treasury pro-

263. Treas. Release No. B-1758, at 7-14. The Treasury's proposal has received support from the New York State and American Bar Associations. See *Joint Report on H.R. 3899 Simplification of Installment Sale Reporting*, 33 TAX LAW. 349 (1980).

264. Treas. Release No. B-1758. Instead of "discount payments," Release B-1758 uses the term "collection gain."

265. See *id.* 11.

266. See note 216 *supra*. Many may feel, however, that this treatment of discount payments would create a new problem because of the similarity of the payments to interest income. See text accompanying notes 210-23 *supra*. Rather than relying on *Arrowsmith*, the Treasury proposal would amend section 1232(a) to equalize notes issued by corporate and noncorporate obligors. Thus, discount would receive favorable capital gain treatment not only in the case of purchaser obligations but also obligations purchased for cash, and even third-party obligations generally. This kind of tampering with the fundamental sale-or-exchange requirement for the capital gain preference may well be justifiable as a matter of tax policy, but "reform" would seem to be a more appropriate label than "simplification."

posal still fails to make the fundamental distinction between the appropriate application of the accounting provisions of the Code and the application of the sale-or-exchange provisions. The Treasury is in fact trying to have its cake and eat it too by eliminating the possibility of open-transaction treatment for cash-method taxpayers but retaining use of taxpayer's accounting method—or a very complicated installment provision—for accrual-method taxpayers.²⁶⁷

Problems will remain in the Treasury's approach as long as it fails to recognize that the accounting provisions should apply to transactions in the regular course of business and the sale-or-exchange provisions should apply to isolated or casual transactions. For example, if the Treasury proposal is applied to the facts of the *Wiggins* case,²⁶⁸ a number of difficulties arise. *Wiggins* involved the sale of 1,200 lots in a subdivision under highly speculative contracts. The court was troubled by the Service's attempt to apply section 1001 to each sale because of the difficulty of making so many individual determinations of fair market value. Consequently, it held that the purchaser obligations were without ascertainable fair market value and permitted the cost-recovery method of reporting gain. As discussed above,²⁶⁹ this result could have been achieved much more easily had the court realized that section 1001 has nothing to do with a sale of property in the regular course of business. However, under the new Treasury proposal, *all* sales of real property would be subject to installment reporting unless the taxpayer elects to report the value of the purchaser obligations immediately. If the taxpayer wishes to report his gain on the installment method, that choice is available to him under current law, so the question is what happens to taxpayers who want to use their regular accounting method in disposing of real property in the ordinary course of business. Under the Treasury proposal, the taxpayer apparently would not be free to do so, because an election out of installment reporting would put him into a revised section 1001.

This result would be one that the Treasury has wanted for years. A taxpayer who elects out of installment reporting but is willing to include the full face amount of the purchaser obligation in the amount realized in the year of sale would measure income in that year simply by deducting basis, exactly as an accrual-method taxpayer does now. Consequently, the Treasury proposal would permit accrual-method taxpayers to use their accounting method in reporting gain. However, a taxpayer who includes less than the face value of the purchaser obli-

267. See text accompanying notes 102-07 *supra*.

268. See text accompanying notes 85-95 *supra*.

269. See text accompanying notes 90-92 *supra*.

gation in the amount realized would measure income by deducting from the amount realized only a reduced basis, with the remaining basis allocated to later years. Consequently, a cash-method taxpayer would be denied the opportunity to use his accounting method and essentially would be forced to use installment reporting. The only alternative would be a fair market value method that is more onerous in the year of sale than section 1001 is now and that is complicated even further by the need to allocate basis over a period of years.

The Treasury proposal would thus in effect mandate either the use of an accrual method of accounting or the use of the installment method in all real property sales businesses,²⁷⁰ because it is inconceivable that a rational taxpayer would elect out of installment reporting into the fair market value method proposed. It is unclear how much thought Treasury has given to this aspect of the proposal, but it should avoid plunging headlong into a basic change in the accounting rules without careful consideration. The accounting rules, designed to measure the income from business activities, have been in effect for some time. The regulations in theory have long permitted the use of one of the standard accounting methods as an alternative to the installment method,²⁷¹ and if the method chosen does not adequately reflect income, the Service is authorized to require another method that better reflects income in the particular case.²⁷² There probably are many kinds of businesses that involve regular sales of something that could be called real property, and it is far from clear that all of them would be best served by the accrual method or the new installment approach.

The Treasury proposal could presumably be modified to exclude regular sales of real property from the mandatory installment approach and include only casual sales. As discussed above,²⁷³ however, there are disadvantages to a mandatory installment approach even in the case of casual sales, and one must ask whether there are benefits from the proposal that outweigh its disadvantages. The availability of installment reporting for contingent-price contracts is indeed an advantage, but this could be permitted under current law by regulation.²⁷⁴ Moreover, if statutory authorization is deemed necessary or appropri-

270. The mandatory either/or approach of the Treasury proposal would apply to "gain on any sale of real property or casual sale of personal property . . ." Treas. Release No. B-1758, at 8. Installment reporting for dealers in personal property would presumably remain available under section 453(a), and the proposed change would apparently leave personal property dealers free to choose a system of accounting to report income as they have in the past.

271. Treas. Reg. § 1.453-1(e) (1958). See text accompanying note 43 *supra*.

272. § 446(b).

273. See text accompanying notes 189-92 *supra*.

274. See text accompanying notes 252-53 *supra*.

ate, the statute could be broadened to include contingent-price contracts and still be an elective provision.²⁷⁵ Therefore, the only significant advantage, from the Service's point of view, is the elimination of the open-transaction approach to reporting gain from payments on purchaser obligations. The argument that an obligation has no ascertainable fair market value would still be available to taxpayers who receive third-party obligations, and in fact the statutory elimination of cost recovery in the one case might actually enhance its use in the other, because it would show that Congress could have eliminated this particular loophole if it had wanted to do so. As argued in this Article,²⁷⁶ the open-transaction approach has no real basis in tax policy once the problem of contingent-price purchaser obligations is addressed by making them available for installment reporting. One must therefore ask whether the Treasury proposal is not statutory overkill. Its advantages could be obtained without its disadvantages.

There has been considerable opposition to the full Treasury proposal, and Professor Ginsburg has suggested a compromise in which the 30% and two-payment rules would be eliminated and the Service would be given a statutory mandate to propose regulations making contingent-price contracts eligible for installment reporting.²⁷⁷ This compromise proposal would retain the election-out feature of the Treasury proposal, but taxpayers who choose to elect out of the installment method would fall under current law. Consequently, installment reporting would not be mandatory in principle or in practice, and cost recovery would still theoretically be available for taxpayers who elect out and prove that their purchaser obligations had no ascertainable fair market value. The requirement for an affirmative election out, however, would insure a signal to the Service that the particular return might be worthy of an audit.²⁷⁸ This is likely to deter taxpayers who might otherwise claim open-transaction treatment in the hope that they will not be audited.²⁷⁹ Further, this approach would leave section 1001

275. Professor Ginsburg has suggested this approach. See text accompanying notes 277-82 *infra*.

276. See text accompanying notes 241-58 *supra*.

277. M. Ginsburg, Proposed Specifications for a Circumscribed Legislative Approach to Simplification of Installment Sale Reporting (Nov. 21, 1979) (unpublished memorandum delivered to Bernard M. Shapiro, Chief of Staff, Joint Committee on Taxation) (copy on file with the author). This memorandum outlines some of the opposition to the Treasury proposal.

278. *Id.* 13-15. On the other hand, the Service could probably revise its forms for reporting gain from property sales to insure the desired signal even under present law.

279. Deterrence would be especially strong if taxpayers were denied the opportunity to elect installment reporting as an alternative to their open-transaction claims. Under current law, alternative election appears permissible, see note 255 *supra*, but this situation would likely change when the taxpayer affirmatively elected out of installment sale treatment. Indeed, this may be the

available for those taxpayers who prefer taxation pursuant to the current treatment of closed transactions.²⁸⁰ Like the Treasury proposal, the compromise in its present form does not distinguish between casual and regular sales of real property. In principle, this flaw would not matter, because the taxpayer can elect to report under current law, which allows businesses to use one of the standard accounting methods and to avoid section 1001. However, there is no assurance that the Service will abide the use of accounting methods for sales rather than try to force section 1001 into application, as it did in *Wiggins*. Moreover, because election out requires an affirmative act, businesses that fail to elect out may be forced to fight the Service's attempts to revise their books to account for income under the new installment method. As the *Wiggins* case indicates, any real estate business now on the cash method should be prepared to defend against such action by the Service.

This compromise approach and the approach suggested by this Article would yield essentially the same end result for isolated-sale contingent-price contracts: they would eliminate, as a practical matter, the open-transaction approach for isolated sales of property and make installment reporting and section 1001 the sole alternatives. The statutory amendment would probably eliminate litigation over the open-transaction approach more quickly.²⁸¹ Under the current statutory scheme, the Service would have to adopt regulations permitting installment reporting under contingent-price contracts and then convince the courts that the no ascertainable fair market value approach was thus preempted.²⁸² Under the statutory amendment, regulations would still be necessary, but after their adoption few taxpayers would be so intrepid as to litigate their eligibility for open-transaction treatment. Even if the issue were litigated under the new statute, the analysis presented above, arguing that open-transaction treatment should be denied when section 453 is available, would still be valid. The compro-

strongest argument for a statutory election-out procedure. When the taxpayer can elect in the alternative, the Service not only has to make the first move, but the taxpayer also has a comfortable fall-back position if he loses the litigation over cost recovery. Given the Service's limited enforcement resources, there is much to be said in favor of requiring all taxpayers to fix their positions at an early stage in the process.

280. Professor Ginsburg suggests retaining the idea of amending section 1232(a) to give sale-or-exchange treatment to discount payments or, as he also says, "collection gain," regardless of whether the obligor is a corporation or an individual. This suggestion might give additional inducement to elect out. Ginsburg memorandum, *supra* note 277, at 20-21.

281. This assumes that the new provision would be interpreted to prohibit an installment election in the alternative. See note 279 *supra*. Far fewer taxpayers would then be expected to seek open-transaction treatment.

282. See text accompanying notes 244-58 *supra*.

mise approach would have no effect on the principal thesis of this Article. The correct statutory interpretation would still involve a distinction between isolated sales and those in the regular course of business.

In sum, aside from eliminating the 30% and two-payment rules, neither the Treasury proposal nor the compromise approach is necessary. The problem of contingent-price contracts can be resolved by regulation under current law, and once this is done, the open-transaction doctrine will be eliminated naturally through proper interpretation of the current statutory scheme. By following this route, the Service would accomplish its objectives without violent statutory change. Enacting the compromise proposal would likely have the same effects without causing untoward problems, provided some distinction were made between regular and casual sales of real property. The election-out feature would probably be an improvement in cases of isolated sales, and the stimulus of the statute might more quickly prompt new regulations to solve the problem of contingent-price contracts. The Treasury proposal, on the other hand, would apply a sledge hammer to a walnut. Open transactions are simply not a sufficiently serious problem to require new mandatory accounting rules adopted without careful thought about their ramifications. Moreover, the problem can be handled through less drastic means.

2. *Timing of the Discount—Prorating the Discount Following Closed Transactions.* The preceding discussion focused on the character of the gain attributable to the discount payments on a purchaser obligation. In short, it appears under current law that discount payments following a closed transaction will be treated as ordinary income. The *Arrowsmith* case, however, supplies one possible rationale for treating the discount payments on both fixed-price and contingent-price purchaser obligations as capital gain. This approach may apply whether the transactions are open or closed.²⁸³ Furthermore, if one insists on distinguishing between fixed- and contingent-price contracts, it is still possible to give capital gain treatment to the discount payments on contingent-price contracts. This alternative analysis treats all sales transactions involving contingent-price purchaser obligations as open unless they are eligible for section 453's installment method.²⁸⁴

To the extent section 453 is available and elected, that statute governs both the character and the timing of the discount payments. If the transaction is held open, basis is recovered before any gain is recog-

283. See text accompanying notes 237-40 *supra*.

284. See text accompanying notes 241-43 *supra*.

nized; after basis is recovered, all payments become income when received and maintain the character of the underlying transaction. When the transaction is closed under section 1001, however,²⁸⁵ it is necessary to determine the timing of the discount gain, regardless of whether the discount is treated as capital gain or ordinary income.

To take a simple example, suppose a taxpayer sells property in which his basis is \$250. He receives a \$1000-face-amount note, payable at \$100 per year for ten years, together with sufficient interest to avoid section 483. Assume that the note has a fair market value of \$500 in the year of sale. If taxpayer does not elect under section 453, he will have a \$250 gain in the year of sale and, if the note is paid in full, \$500 additional gain at some point from discount payments. Because his basis in the note is now \$500, the question is whether he can recover that basis before reporting any discount gain or must rather prorate each payment between return of basis and discount income. Clearly, this problem arises whether the discount is treated as capital gain or as ordinary income. Of course, it usually arises only in cases involving fixed-price contracts, because it is difficult, when the total price is contingent, to decide what percentage of each payment is appropriately termed "discount."

Many of the cases that have considered whether to require prorating the discount involved third-party obligations, either purchased for cash or received on corporate liquidation, rather than purchaser obligations. However, for the purpose of deciding the timing of the gain, as opposed to its character, this distinction is arguably of little force; in either case the obligation may be considered to have been purchased, in one case for cash and in the other for property.²⁸⁶ Accordingly, the courts have developed a fairly uniform black-letter rule: the discount on both third-party and purchaser obligations must be included in income pro rata unless the obligation is speculative.²⁸⁷ Whether an obli-

285. The transaction will almost always be closed under the approach suggested in this Article, unless section 453 is elected or is unavailable as a result of contingencies that do not involve a breach of the purchaser's legal obligations.

286. See note 216 *supra*.

287. For purchaser obligation cases, see, *e.g.*, *Riss v. Commissioner*, 368 F.2d 965 (10th Cir. 1966); *Witte v. Commissioner*, 31 T.C.M. (CCH) 1137, 1142-43 (1972), *remanded for further proceedings*, 513 F.2d 391 (D.C. Cir. 1975); *Potter v. Commissioner*, 44 T.C. 159, 178 (1965), *acq.* 1966-1 C.B. 3; *Shafpa Realty Corp. v. Commissioner*, 8 B.T.A. 283, 284-85 (1927). For third-party obligation cases, see, *e.g.*, *Darby Inv. Corp. v. Commissioner*, 315 F.2d 551, 553 (6th Cir. 1963); *Willhoit v. Commissioner*, 308 F.2d 259, 263-64 (9th Cir. 1962); *Phillips v. Frank*, 295 F.2d 629, 633-34 (9th Cir. 1961); *Smith v. Commissioner*, 48 T.C. 872, 879 (1967), *aff'd in part and rev'd in part*, 424 F.2d 219 (9th Cir. 1970); *General Ins. Agency, Inc. v. Commissioner*, 26 T.C.M. (CCH) 656, 662 (1967), *aff'd*, 401 F.2d 324 (4th Cir. 1968); *Underhill v. Commissioner*, 45 T.C. 489, 492 (1966). Of these cases, only *Willhoit*, *Phillips*, and *Underhill* found that the obligations were suffi-

gation is speculative is determined by the same basic factors that are used to determine the value of the obligation—whether the debtor is personally liable, whether there is a guarantor, whether the obligor is in substantial default on payments due, the size of the discount, the ease of marketability, the terms of payment, and the amount of security.²⁸⁸

Despite the formidable authority in support of this black-letter rule, a coherent interpretation of the statutory framework suggests a different treatment for fixed-price purchaser obligations as opposed to third-party obligations. First, there is little logic to a test that determines the timing issue by reference to whether the obligation is speculative. As discussed above,²⁸⁹ in the case of a fixed-price contract, any discount from face may be considered a measure of the degree of speculation; the instrument might just as well be considered to have a lower face amount and a higher express interest rate. Even after several payments have been made on the obligation—when, for example, the obligee has received an amount equal to his basis—the obligation presumably retains value that is at least potentially realizable by sale. Thus, a \$1000 obligation originally acquired for \$100 may still be worth \$80 to \$90 after \$100 has been paid on it, while a similar but less risky obligation acquired for \$800 is still likely to be worth around \$150 after \$800 has been paid. There is no logical ground for distinguishing these situations on the issue of basis recovery. One cannot say that the first case is speculative and the second is not. Both are speculative, although in differing degrees. While this difference is appropriately reflected in the amount of each payment that is includable in income—a matter that is handled automatically by requiring that both be prorated—it cannot reasonably be expected to serve satisfactorily as an all-or-nothing test. Therefore, if prorating is required at all, it should be required uniformly. As discussed below,²⁹⁰ the only rational basis for an exception would be a purchaser obligation for which section 453 was either unavailable or unelected.

Second, the basic point of this Article is that isolated sales of property should be taxed under section 1001 except when the installment sale provisions provide tax relief. In other words, sections 1001 and 453 should be read together. The installment provisions offer significant benefits, especially as compared with section 1001. The price the taxpayer pays for these benefits, however, is that he must report all of

ciently speculative to permit the taxpayer to reclaim his basis before including any discount in his income.

288. *Underhill v. Commissioner*, 45 T.C. 489, 494 (1966).

289. See text accompanying notes 217-23 *supra*.

290. See text accompanying notes 291-93 *infra*.

his gain, including that from the discount payments, pro rata. Section 1001, on the other hand, requires the taxpayer to include a sizeable gain in his income immediately, though he has received little or no cash with which to pay the tax. Because section 1001 gives the government its main tax bite early, it is not unreasonable to ask the government to wait for the rest. Especially since almost all sales transactions involving a fixed-price purchaser obligation can be structured to qualify for section 453 treatment, delaying taxation of the discount seems a sensible quid pro quo. Just as the existence of section 453 makes it more reasonable to treat the discount payments on a purchaser obligation as ordinary income when reported under section 1001,²⁹¹ the requirement that the entire gain be reported ratably under section 453 supplies a rationale for permitting recovery of basis before reporting such ordinary income under section 1001.

Section 453 is unavailable, however, for reporting gain from third-party obligations received upon the sale of property.²⁹² These obligations are therefore more appropriately viewed as having been purchased for their fair market value by the seller of the underlying property. Discount payments in this case are difficult to distinguish from interest,²⁹³ and because money is fungible there is no reason not to require that this income be reported in a manner more natural than a balloon payment at the end. Thus, while the amortization-of-discount requirement does not affect the suggested interpretation of section 1001, that interpretation does cast light in the other direction and suggests that discount be prorated on all third-party obligations but not on fixed-price purchaser obligations.

3. *Summary.* Neither the traditional approach to taxing closed transactions nor a requirement to amortize the discount payments over the life of the obligation justifies retaining the current ad hoc approach to the relationship between section 1001 and the accounting provisions. Accounting-method concepts, quite simply, should play no role in taxing isolated sales of property. Rather, difficulties perceived in the operation of section 1001 should be analyzed in conjunction with the installment sale provisions under section 453. A strict either/or application of these two provisions is the most rational interpretation of the Code for isolated transactions, but this puts additional pressure on the conditions under which the ameliorative installment sale provisions are available. Absent statutory reform, the best way to relieve this pres-

291. See text following note 223 *supra*.

292. See note 191 *supra*.

293. See text accompanying note 223 *supra*.

sure, which arises primarily for contingent-price purchaser obligations, is to treat as open all transactions that cannot qualify for section 453 treatment because of the contingency.

C. *Other Limitations on Installment Reporting.*²⁹⁴

1. *The 30% Initial Payment Limitation.* Upon an isolated sale of personal property or any sale of real property, section 453 is available only if the payments to the seller in the year of sale constitute less than 30% of the selling price.²⁹⁵ The original idea behind this limitation was that the receipt of more cash in the year of sale would enable the seller to pay the taxes due under section 1001. Therefore, the relief of installment sale treatment was thought unnecessary.²⁹⁶

In fact, the 30% rule serves no useful purpose. First, the 30% rule prevents installment-method reporting in many transactions though the seller receives little or no cash in the year of sale. Moreover, in the case of fixed-price contracts, if the taxpayer consults his tax advisor before culminating the sale, he can almost always structure the transaction to satisfy the 30% rule without significantly diminishing the amount of cash he receives or delaying those receipts for very long after the closing.²⁹⁷ Finally, the rule may even have a detrimental effect on government revenue flow. Many taxpayers may delay receipt of funds that, on purely commercial considerations, would have changed hands at the closing, simply to insure qualification for installment-method reporting. Because the transactions then qualify, the government gets its taxes later.

Nonetheless, the 30% rule is statutory, and its elimination requires congressional action. As long as it remains in the Code, taxpayers must be wary of the pitfalls²⁹⁸ that it presents. For our purposes, it is sufficient to note that the 30% rule should not affect the suggested interpretation of section 1001. In the case of fixed-price contracts, section 453 is always available if the transaction is carefully structured. Therefore, if the taxpayer falls into a 30% rule trap upon an isolated sale, he should be taxed under section 1001 without any reference to his method of

294. Legislation has been introduced that would eliminate the 30% rule and the two-payment rule as limitations on eligibility for installment reporting. S. 1063, *supra* note 260; H.R. 3899, *supra* note 259. See text accompanying notes 259-61 *supra*. When and if this legislation is adopted, the issues discussed in subsections 1 and 2 of this section will become moot.

295. § 453(b)(2).

296. *See, e.g.,* *Tombari v. Commissioner*, 299 F.2d 889, 891 (9th Cir. 1962); S. REP. NO. 52, *supra* note 37, at 19, 1939-1 C.B. (pt. 2) at 346-47; H.R. REP. NO. 704, *supra* note 244, at 24, 1939-1 C.B. (pt. 2) at 572.

297. *See generally* Ginsburg 482-83.

298. Professor Ginsburg has done an admirable job of analyzing these pitfalls. *See id.* 482-90.

accounting. As noted above,²⁹⁹ contingent-price contracts are not presently eligible for installment-method reporting under section 453. Consequently, the sales in these cases should be treated as open in the traditional sense, at least to the extent of the contingency.

If the Service follows this approach and attempts to adopt new regulations permitting installment reporting for contingent-price purchaser obligations, it may have trouble incorporating the 30% rule. At first glance, it might appear that the new regulations would define the total contract price and gross profit, so that the 30% limitation could rationally be tied to those definitions. The statute, however, only requires that the *ratio* of gross profit to total contract price be ascertained and that ratio may in many cases be much easier to define than the two numbers independently.³⁰⁰ One draconian possibility would be to limit the initial payments to 30% of any fixed or guaranteed price under the contract. This limitation would likely result in numerous unnecessarily artificial delays in payment under the contract until the seller's tax year following the year of sale. Such deferral of payment may seem ridiculous, but it has the advantage of clearly satisfying the statutory requirement. If the Service were to follow an enlightened tax policy, it might allow alternative approaches that would in all likelihood pass muster under the statute.³⁰¹

299. See text accompanying notes 241-58 *supra*.

300. For example, when the seller's basis is very low, there may be grounds for treating all of each payment as gain and permitting recovery of basis only out of the final payment. See note 253 *supra*. Alternatively, in the case of a payment period with a time limitation, basis could be recovered ratably over the period, with any excess in a given year treated as income. This approach in essence skirts the definitions of total contract price and gross profit, but it could probably be supported under the broad authority given to the Service to draft regulations.

301. In fact, if the ratio of gross profit to total contract price can be reasonably estimated, either amount can in principle be calculated from the seller's basis in the property. As a simple example, consider the case of a sale of unmortgaged property, with the selling price (SP) and the total contract price (TCP) equal. The gross profit (GP) is equal to the selling price less the seller's basis (B). If we are given the ratio (R) for determining the percentage of each payment that must be included in income, then $GP/TCP = GP/SP = R$. Substituting $GP = SP - B$ into the equation $GP/SP = R$, we obtain the equation $(SP - B)/SP = R$. One can easily solve this latter equation for SP to obtain $SP = B/(1-R)$. The amount of payments that the seller may receive in the year of sale without losing eligibility for installment method reporting could then be set at 30% of the selling price calculated from this formula.

Interestingly enough, it is possible to use exactly the same approach even if the property is mortgaged, whether or not the mortgage exceeds basis. The total contract price approaches the gross profit as the amount of the mortgage reaches the seller's basis, and the total contract price equals gross profit when the mortgage equals or exceeds basis. Treas. Reg. § 1.453-4(c) (1960). Thus, the extent to which the property is mortgaged will affect the percentage of each payment that must be included in income, and 100% of the payments must be included whenever the mortgage equals or exceeds basis. Nevertheless, although the definition of the total contract price necessarily starts from the selling price and decreases with the amount of the mortgage, the selling price itself is never affected by the existence of a mortgage. Therefore, we simply determine the

In any event, until Congress or the Service speaks on the matter, we must live with sections 453 and 1001 in their current forms. The interpretative approach suggested in this Article is clearly consistent with the statutory scheme. It assures that installment reporting or open-transaction treatment will always be available to a taxpayer seeking to avoid the harshness of section 1001. It is fair in the sense that roughly similar tax opportunities will be presented to similarly situated taxpayers. Further, these benefits are achieved in a manner that highlights some of the deficiencies of the current scheme (such as the 30% rule) and thereby encourages administrative, and possibly legislative, reform. Therefore, the existence of and the problems presented by the 30% rule should not be permitted to cloud the more fundamental statutory interpretation issues.

2. *The Two-Payment Rule.* The Service maintains that a sale of property for which a lump-sum payment is to be made in a subsequent tax year is ineligible for qualification under section 453; at least two payments in two separate tax years are necessary.³⁰² This position is utterly irrational. Nevertheless, both the Tax Court³⁰³ and the Court of Claims³⁰⁴ have upheld the Service on this point, on the ground that "lump sum" and "installment" are contradictory terms. There can be no policy justification for permitting one taxpayer who takes a minimal downpayment in the year of sale together with a contract for a lump sum in a later year to report under section 453, while denying that privilege to another who sells identical property under identical terms except for the absence of a downpayment. In fact, the first taxpayer is

ratio R' from the regulations for the case in which the mortgage is assumed to be zero. (By hypothesis, the regulations have a rational means of producing this ratio.) Our estimate of the selling price is then $SP = B/(1-R')$. We then use the selling price so calculated to determine eligibility for installment reporting under the 30% rule. Once eligibility is determined, the correct ratio R for the actual problem, in which the property is subject to a mortgage, should be used for the percentage of each payment that must be included in income.

Finally, even if the seller's basis has been reduced, for example, by depreciation deductions, there is nothing wrong with using his original basis for the estimate of the selling price. What we are seeking is a rational method for determining compliance with the 30% rule, and for this purpose taking money out of the property through depreciation deductions from other income is no different from borrowing on the property subject to a mortgage.

One approach that clearly should not be taken to the 30% rule for contingent-price contracts is one based on the fair market value of the contract. This approach would leave eligibility for installment reporting completely unpredictable and would be a frequent source of litigation over value that, by its very nature, can never be measured satisfactorily. In fact, elimination of valuation problems was part of the impetus for the original adoption of the predecessors of section 453. S. REP. No. 52, *supra* note 37, at 19, 1939-1 (pt. 2) C.B. at 346-47.

302. Rev. Rul. 69-462, 1969-2 C.B. 107.

303. 10-42 Corp. v. Commissioner, 55 T.C. 593, 596-97 (1971), *nonacq.* 1972-2 C.B. 4.

304. Baltimore Baseball Club, Inc. v. United States, 481 F.2d 1283, 1286 (Ct. Cl. 1973).

clearly in a better position to pay taxes under section 1001 because he has actually received something in the year of sale.³⁰⁵ Fortunately, in contrast to the 30% rule, the statute does not compel this interpretation.³⁰⁶ One can hope that the Service will reverse its position administratively. More realistically, perhaps, the next time an unfortunate taxpayer falls into this trap, the courts should reverse the ill-considered judicial approval of the two-payment limitation. Section 1001 often operates harshly, and Congress has attempted to provide a method of relief that in general works fairly well. An approach that truly treats section 1001 and section 453 as Congress intended—as the exclusive but alternative methods of reporting gain from the isolated sale of property—can only be expected to work if the two sections are interpreted in a manner consistent with their underlying policy: when the taxpayer receives insufficient cash in the year of sale,³⁰⁷ installment reporting should be available to mitigate the harshness of section 1001. The system is too complicated to expect Congress to come to the rescue every time the Service puts up roadblocks. In the case of the two-payment rule, the courts need not even go to the extreme of importing an independent concept like the open-transaction doctrine to induce administrative action more in line with the statutory policy. They can, and should, simply overrule the conflicting administrative position.

3. *Interaction of Section 453 with Other Nonrecognition Provi-*

305. For additional, similar criticisms of the two-payment rule, see Ginsburg 483-84.

Current section 453(a), concerning regular dealings in personal property, refers to "installment payments actually received" as the payments to which the installment method of reporting is applicable. Therefore, the position of the Service is that a single payment in a single year after the sale cannot be an installment payment. Section 453(b), dealing with sales of real property and casual sales of personal property, then refers to returning income in the manner prescribed in section 453(a), the source of the two-payment rule for those transactions. The proposed legislation, see note 259 *supra*, would not expressly eliminate the two-payment rule for section 453(b) transactions. It would do so implicitly, however, by defining an installment method especially for section 453(b) and eliminating the word "installment" that now appears in the phrase "installment payments actually received" in section 453(a). Thus, any payment under section 453(b) would be taxed only in the year actually received, even if there is only one payment. Presumably, the two-payment rule would survive for personal property dealings reported on the installment method under section 453(a), although the policy basis for this distinction is not clear.

306. To treat a lump-sum payment as a single installment does not so offend the language that we should permit irrational and inequitable results contrary to statutory policy. Moreover, section 453(b), which covers the sales at issue, does not even use the word "installment." It simply permits income from eligible sales to be reported (admittedly under regulations prescribed by the Secretary) in the manner prescribed in section 453(a). Section 453(a) does use the terms "installment plan" and "installment payments," but those terms do not define the manner of reporting the gain. One hesitates to rely on this type of technicality, however, because it concedes at least the potential validity of the two-payment rule with respect to dealers who wish to report under section 453(a).

307. *I.e.*, less than 30% of the selling price.

sions. The general interpretation suggested in this Article—to read section 1001 and section 453 as the exclusive either/or choice upon the isolated sale of property—requires refinement when a special nonrecognition section applies to the particular transaction. Nonrecognition is allowed, for example, upon a transfer of appreciated property to a controlled corporation under section 351; in a corporate reorganization under section 368; or in an exchange of like-kind property under section 1031. The law is at best thinly developed in these areas,³⁰⁸ but it is possible to make a few general observations on how the proposed interpretation of section 1001 should apply in these cases.

When property is exchanged for other property, section 1001 usually requires recognition of the gain or loss realized. If no special nonrecognition section applies, section 453 is available in eligible cases to permit variation of this section 1001 recognition. When a special nonrecognition section fully applies, however, new property is acquired, usually with a carryover basis, and recognition of gain is postponed until the new property is disposed of in a taxable transaction. There is, therefore, neither any need nor any justification for forcing application of section 453's installment method to the nonrecognized gain from the sale of the underlying property. Rather, it makes more sense to wait until the new property is disposed of in a transaction to which section 1001 would otherwise apply and then to ask whether that second disposition is eligible for installment reporting. The Fifth Circuit, at least, appears to have adopted this view.³⁰⁹

More difficulty arises when boot is received in these kinds of transactions. In most instances gain is recognized to the extent of the fair market value of the boot.³¹⁰ If the boot is a purchaser obligation, the question is whether section 453 is available to report the gain and, if so, how. The simplest approach is to break the transaction into two parts and consider part of the underlying property as being exchanged tax free and the remainder as being sold for the boot. Unfortunately, this approach does not comport with the statutory provisions. It suggests that the basis of the underlying property should be apportioned between the two purportedly separate parts of the transaction, but the provision for full taxation to the extent of the boot is to the contrary. Nevertheless, the basis of the property sold in no way affects the method of reporting the gain, and this aspect of the nonrecognition transaction can therefore usually be regarded simply as a special basis

308. Professor Ginsburg has briefly summarized the current state of the law. See Ginsburg 505-06.

309. *Dennis v. Commissioner*, 473 F.2d 274, 285 (5th Cir. 1973).

310. *E.g.*, § 351(b).

allocation rule. Thus, if the nonrecognition provision taxes the boot in full, it is equivalent to finding that the part of the underlying property deemed sold for the boot had zero basis. Section 453 should still be available for reporting this gain, provided no more than 30% of the boot consisted of property other than purchaser obligations.

This approach is clearly consonant with sound policy considerations. As to the nonrecognized portion of the gain, the law deliberately assesses no tax until a second disposition. As to the recognized gain, however, there remains the question of whether sufficient cash or other valuable property has been received with which to pay the tax due. The policy behind section 453 applies with equal force to recognition of boot in these transactions.³¹¹

D. *Reacquisitions of Property.*

The seller often reacquires the underlying property upon the purchaser's default or pursuant to another condition of their agreement. Reacquisition under these circumstances presents a number of problems, some of which are unlikely to be resolved without statutory assistance.³¹² One that could be solved administratively is the utter chaos in the Service's theory and practice regarding reacquisitions following sales that are not reported under the installment sale provisions of section 453. More difficult, perhaps, is the case of highly appreciated personal property, such as corporate stock, gain from the sale of which *is* reported under section 453. Reacquisition of personal property following a section 453 election represents a potential tax bombshell under the current statutory scheme, and taxpayers should at least pause before electing the supposedly ameliorative provisions.

1. *Reacquisitions Following Sales Under Section 453.* The reac-

311. Unfortunately, the limited existing authority seems to take a different approach. For example, in *Mitchell v. Commissioner*, 42 T.C. 953, 965 (1964), *acq.* 1965-2 C.B. 6, the court upheld the Service's position that the value of like-kind property received in a section 1031 transaction was a payment for the purpose of applying the 30% rule to the purchaser's note taken as boot in the transaction. See generally Ginsburg 512. It does not seem, however, that this decision comports with the policies underlying either the nonrecognition section or the installment sale provisions. In connection with the hearings on proposed legislation to simplify installment reporting, see text accompanying notes 259-82 *supra*, the staff of the Joint Committee on Taxation suggested that it might be more consistent with the basic objectives of installment reporting not to consider the value of like-kind property in installment sales. DESCRIPTION OF H.R. BILLS, *supra* note 262, at 19-20. The Treasury Department agrees, at least in principle. Treas. Release No. B-1758, at 18-19. Consequently, congressional reform may be forthcoming, although the problem could probably also be handled through regulation or enlightened judicial decisionmaking.

312. On the general question of taxing reacquisitions of property, see, e.g., Abbott, *supra* note 216; Murphy *supra* note 216.

quisition problem with the installment sale provisions arises from section 453(d), which provides that when a section 453 installment obligation is satisfied at other than its face value, gain or loss results to the extent of the difference between the amount realized and the seller's basis in the installment obligation. The character of the gain is that of the underlying sale. It was settled fairly early that repossession of property sold, coupled with release of the obligor, constitutes satisfaction at other than face value.³¹³ That is, section 453(d) applies to the repossession, and the amount realized is the fair market value of the property at the time of repossession.

An example will illustrate the enormous burden this rule can place on a seller of highly appreciated property. Suppose the taxpayer has long-term capital-asset property with a basis of \$50. He exchanges that property for the purchaser's promissory note, secured by the underlying property, in the face amount of \$1000, payable \$100 per year (plus sufficient interest to avoid section 483 imputation) beginning one year after the sale.³¹⁴ If the taxpayer elects to report gain under section 453, he will have no gain in the year of sale, and 95% of each payment in subsequent years will constitute long-term capital gain. Now suppose, however, that the taxpayer repossesses the property pursuant to his security interest in the next tax year, after the purchaser defaults on the first payment. If the fair market value of the property at that time is, say, \$500, the taxpayer must recognize long-term capital gain in the year of reacquisition in the amount of \$450.³¹⁵ He recognizes this gain notwithstanding that he has received nothing in the deal and in fact is in exactly the same position as when he started.³¹⁶

Partly in response to a perceived threat that this section 453(d) procedure posed to many businesses,³¹⁷ Congress adopted section 1038 of the Code in 1964. Section 1038 applies by its terms to reacquisitions of real property originally sold subject to a security interest in favor of the seller. It essentially recognizes that the seller has only been restored to his original position, and it taxes the seller on the reacquisition only to the extent he has received pre-reacquisition money or other valuable

313. *United States v. Eversman*, 133 F.2d 261, 265 (6th Cir. 1943); *Boca Ratone Co. v. Commissioner*, 86 F.2d 9, 10-11 (3d Cir. 1936); *Eggerman Inv. Co. v. Commissioner*, 36 B.T.A. 1196, 1198 (1937), *acq.* 1938-2 C.B. 10. These cases were concerned with the predecessor of section 453(d).

314. Inclusion of a downpayment would not change this analysis.

315. § 453(d). The taxpayer's basis in the obligation is its face value (\$1000) less the amount of income that he would return were the obligation satisfied in full (\$950), or \$50. § 453(d)(2).

316. Of course, his property has declined in value, but absent the sale and reacquisition, that would not be a taxable event.

317. *See S. REP. NO. 1361*, 88th Cong., 2d Sess. 6 (1964), *reprinted in* 1964-2 C.B. 828, 833.

property in amounts exceeding the gain reported prior to the reacquisition.³¹⁸ Thus, if the property in our example is real property, the taxpayer has no gain on the reacquisition, and his basis in the reacquired property is what it was prior to the sale. For tax purposes, he is simply returned to his initial position.³¹⁹

It is not clear why the language of section 1038 specifies real property. Certainly there is nothing in the legislative history that indicates a conscious intention to exclude reacquisitions of personal property, and most of the reasons given in support of the section apply with at least equal force to personal property sales: the inappropriateness of measuring repossession gain by the fair market value of the property when the seller is in the same position as before the sale; the difficulties inherent in determining fair market value;³²⁰ the assessment of tax on appreciation that has not yet yielded monetary return; and the desirability of equal treatment in transactions differing only in technical details that are without tax relevance.³²¹ It may have been simply a less than careful response to the Service's regulations, which for some reason have always referred only to real property in connection with reacquisitions³²² but have on occasion been treated as applicable to personal property as well.³²³ If so, it makes sense to extend section 1038, either judicially or administratively, to cover personal property.³²⁴

318. § 1038(b).

319. Note that section 1038 governs only the amount and timing of reacquisition gains and losses; their character, ordinary or capital, must be determined separately. Treas. Reg. § 1.1038-1(d) (1967). The character of reacquisition gain after a sale originally reported under the installment method is that of the underlying sale. § 453(d). For nonsection 453 sales, the Service has maintained for some time that when title is retained in the seller or when title is transferred but reacquired by voluntary reconveyance, the reacquisition gain is ordinary income, presumably on the ground that no sale or exchange has occurred. Treas. Reg. § 1.453-6 (1958). On the other hand, when property is reacquired through foreclosure, it seems that the purchaser obligation may be deemed sold or exchanged, in which case capital gain treatment will be available. Murphy, *supra* note 216, at 822. It is difficult to justify distinctions that turn on such niceties. Abbott, *supra* note 216, at 497-500; Desmond, *Sales of Property Under the Deferred-Payment Method*, 32 TAXES 40, 47 (1954); Murphy, *supra* note 216, at 822-23.

320. In fact, it is probably easier in most cases to assess the fair market value of real property, for which the concept of a market is much clearer, than, for example, to evaluate the stock of a closely held corporation.

321. S. REP. NO. 1361, *supra* note 317, at 5, 1964-2 C.B. at 831.

322. Treas. Reg. §§ 1.453-5 & 1.453-6 (1958). Some of the earlier forms of these regulations are discussed in Haley, *supra* note 34, at 319-20.

323. Abbott, *supra* note 216, at 497 n.26; Murphy, *supra* note 216, at 808; *cf.* G.C.M. 1387, V-1 C.B. 48, 50 (1927) (approved method for computing profit from deferred-payment sale of real estate held applicable to sale of stock), *declared obsolete*, Rev. Rul. 69-31, 1969-1 C.B. 307.

324. Dealers reporting under section 453(a) might justifiably be singled out for different treatment upon reacquisitions, but nothing in the legislative history of section 1038 indicates that Congress wished to do this. A dealer should usually be able to resell a repossessed item fairly quickly, either directly at retail or through the second-hand goods market. Therefore, even if section

Outside the context of section 453, this approach seems feasible. There is neither statutory nor express administrative authority on the problem.³²⁵ In fact, at least two cases involving a pre-1964 reacquisition of personal property sold without an installment-method election came to results essentially indistinguishable from the result section 1038 would now achieve for real property.³²⁶ Nevertheless, when section 453 is elected and the property is later repossessed, one is faced directly with the clear, although harsh, language of section 453(d) and the equally clear literal application of section 1038 only to real property.

It is tempting to suggest that harsh results under section 453(d) primarily occur only with real property. Indeed, personal property is often so severely depreciated by the time of repossession that the reacquisition gain is low. This general analysis, however, misses the mark in many cases. The stock of small but prosperous companies is often sold by the founders at a very high gain. If the buyer is unable at times to run the company well enough to make the payments, the value of the stock may fall from the time of sale, but its value may still be well above the seller's original basis when he reacquires it. Moreover, some stock reacquisitions are the result of internal policy or management disputes causing one of the parties to depart from the business, and the reacquisition under these circumstances may not in any way reflect a lowered value of the stock.³²⁷ Far fewer cases of reacquisition may in-

453(d) requires recognition of significant gain upon repossession, the dealer can probably either realize that gain in cash or at least recognize a cancelling loss upon the resale. Consequently, most dealers may be indifferent to whether the approach of section 453(d) or that of section 1038 is used. Moreover, even if dealers should be excepted from the section 1038 approach, a different rationale is necessary for isolated sales of personal property under section 453(b).

325. *But see* Held v. United States, 1975-2 U.S. Tax Cas. ¶ 9678 (N.D. Ala. 1975). The Held taxpayers sold corporate stock for a note secured by the stock. They exchanged the note for a mortgage on real property and subsequently acquired the property upon foreclosure of the mortgage. The court held that section 1038 did not apply because taxpayers sold corporate stock rather than real estate.

326. *Lowe v. Commissioner*, 44 T.C. 363 (1965), *acq. in result* 1966-1 C.B. 2; *Deatherage v. Commissioner*, 23 T.C.M. (CCH) 1410, 1413-14 (1964). The *Lowe* facts gave the court a rare opportunity to clarify important points of law in this area. Unfortunately, the stipulations and concessions of both sides (whether a result of inadequate understanding of the issues or conscious strategy) led to an opinion so opaque in both its assumptions and conclusions that it cannot serve as compelling authority. The case is discussed at length by Abbott and Murphy. Abbott, *supra* note 216, at 494; Murphy, *supra* note 216, at 826-30.

327. *See, e.g., Spencer v. Granger*, 102 F. Supp. 205, 209 (W.D. Pa. 1952). In *Spencer* a third shareholder-partner was brought into a business, giving a note in exchange for highly appreciated stock amounting to one-third of the total stock outstanding. The seller reported his gain on the exchange under the installment method, but he reacquired the stock two years later for what amounted to a cancellation of the note, in order to effect a shift of corporate control. The court found a gain under the predecessor of section 453(d) and approved a valuation of the stock that was essentially equal to the original sale price.

volve personal property than real property, and it will undoubtedly be more difficult to generate the necessary political support for a legislative change. Nevertheless, this situation only highlights and certainly does not justify the inequity of treating the two types of sellers so differently.

2. *Reacquisitions Outside Section 453.* The law is very unclear on the taxation of reacquisitions after sales not reported under section 453. Reacquisitions of real property are governed by section 1038 regardless of the method of accounting for the underlying sale, although the character of the gain is determined on other grounds.³²⁸ With respect to personal property, however, all one can say with any confidence is that reacquisitions under section 453 may be painful; we simply do not know whether things are better when gain is initially reported under section 1001. The problem is that the only regulations published by the Service covering reacquisitions outside section 453—not including those adopted under section 1038—by their terms cover only real property.³²⁹ These regulations provide that gain is recognized in the year of reacquisition in an amount³³⁰ that depends on whether title to the underlying property has passed. If title remains in the seller, the amount of the gain is essentially equal to that determined under the section 1038 approach.³³¹ If title has passed to the buyer, the amount of the gain is determined in the manner now fixed for section 453(d), which looks to the fair market value of the property at the time of reacquisition.³³²

These regulations by their terms apply only to real property,³³³ and are now, of course, superseded by section 1038. Therefore, even if they were applicable by analogy to personal property, as some commentators have assumed,³³⁴ the appropriate analogy would now be to section 1038 rather than to the obsolete regulations. Moreover, only a few reported cases involve non-installment-method reacquisitions of personal property following a completed sale,³³⁵ and in at least two

328. See note 319 *supra*.

329. Treas. Reg. § 1.453-6 (1967).

330. The character of the reacquisition gain under the regulations is more complicated, see note 319 *supra*, and only adds to the chaos of attempting to decide whether the regulations extend to personal property.

331. Treas. Reg. § 1.453-6(b) (1967).

332. *Id.* § 1.453-6(c).

333. *Id.* § 1.453-6(d).

334. See sources cited in note 323 *supra*.

335. Considerable litigation has arisen on both the buyer and seller sides in the case of options or defaulted executory contracts of sale. This litigation has frequently focused on the character of gain or loss to one of the parties. *E.g.*, Turzillo v. Commissioner, 346 F.2d 884 (6th Cir. 1965)

cases the Service successfully pressed for a result contrary to the regulations.³³⁶ At least on their facts, these cases hold that the reacquisition-year gain should be determined independently of the fair market value of the property, notwithstanding that title had passed.³³⁷ Therefore, one can only speculate about the outcome of a case today, or even about the Service's position in a new case.

The stage is clearly set for a complete abandonment of the Service's old distinction between passage and retention of bare title. This distinction has received almost universal scholarly condemnation,³³⁸ and even at an early stage it was subjected to judicial criticism.³³⁹ Once sufficient indicia of sale and/or transfer have occurred to trigger realization of gain or loss, the gain on subsequent repossession should not depend on the formalities of the security interest pursuant to which repossession is effected. If the law ever applied this distinction by analogy to personal property reacquisitions, there is no longer any support for it in statute, rule, or regulation. The real property regulations on which it was based have been superseded, and we now write on a clean slate. This is surely no time to resurrect the distinction.

If it be granted that distinctions based on retention of bare title should not govern the reacquisition gain, it remains to decide whether the approach of section 1038 or that of section 453(d) should apply to personal property reacquired subsequent to a non-installment-method sale. There is a certain logic and considerable judicial authority³⁴⁰ for the proposition that repossession, particularly in a subsequent tax year, is a separate transaction from the underlying sale. Absent contrary statutory authority, the principle of annual accounting for income logi-

(release of rights by optionee for consideration); *Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938) (optionor taxation), *cert. denied*, 307 U.S. 630 (1939); *Binns v. United States*, 254 F. Supp. 889 (M.D. Tenn. 1966) (liquidated damages received by seller on default), *aff'd*, 385 F.2d 159 (6th Cir. 1967); *Smith v. Commissioner*, 50 T.C. 273 (1968) (settlement received by seller on default), *aff'd per curiam*, 418 F.2d 573 (9th Cir. 1969); *Bihlmaier v. Commissioner*, 17 T.C. 620 (1951) (tax treatment of buyer on forfeiture of downpayment upon buyer's default), *acq.* 1952-1 C.B. 1.

336. *Lowe v. Commissioner*, 44 T.C. 363 (1965), *acq. in result* 1966-1 C.B. 2; *Deatherage v. Commissioner*, 23 T.C.M. (CCH) 1410 (1964). See also note 326 *supra*.

337. 44 T.C. at 372; 23 T.C.M. (CCH) at 1413. Neither *Lowe* nor *Deatherage* is express in its holding, and as mentioned above, see note 326 *supra*, the *Lowe* opinion is very confusing. Nevertheless, the result in each case was that the amount of reacquisition gain was determined without reference to the fair market value of the underlying property.

338. See, e.g., the sources cited at the end of note 319 *supra*.

339. *Boca Ratone Co. v. Commissioner*, 86 F.2d 9, 11-12 (3d Cir. 1936). See also *Frost v. Commissioner*, 37 B.T.A. 190, 193-95 (1938) (Tyson, J., dissenting), *acq.* 1938-2 C.B. 12; Rev. Rul. 80-58, 1980-9 I.R.B. 16, 17.

340. E.g., *Pacific Refrigeration Co. v. Commissioner*, 2 T.C.M. (CCH) 141, 142 (1943); *Gillies v. Commissioner*, 20 B.T.A. 570, 572 (1930).

cally compels treating repossession as a new sale or other disposition of the purchaser obligation.³⁴¹ In this case, however, section 1001 would require measuring gain or loss by the fair market value of the property received, which of course is the property originally sold in the prior year. This line of reasoning thus leads to adoption of the section 453(d) approach. The rule has the advantage of putting all personal property sales on equal footing with respect to repossession, since the total gain or loss, after all the dust has cleared and the seller has his property back, is the same whether the original sale is reported under the installment method of section 453 or under section 1001.³⁴² Finally, and for the purposes of this Article most important, adopting a rule that measures reacquisition gain or loss by the fair market value of the reacquired property in the year of reacquisition, even beyond sales under section 453, would preserve the straightforward structure of sections 1001 and 453 that Congress intended. Section 1001 would govern all isolated sales transactions independent of the taxpayer's method of accounting, except insofar as the taxpayer has elected the ameliorative provisions of section 453.³⁴³ The taxpayer could decide which section to report under without worrying about differences that might arise out of a future reacquisition: the results would be the same regardless of his choice. Because predictions of future events are hazy at best, elimination of the need for them is surely helpful in tax planning.

341. Treatment as a "sale or other disposition" should apply even if the original sale was an open transaction. For example, assume an open transaction in which the seller receives cash in excess of his basis in the year of sale. Once that year ends, the principle of annual accounting would generally forbid recalculating his income for that year, but it is equally true that, upon reacquisition, his transaction with the purchaser is closed. He no longer holds the obligation, he has the property back, and nothing more can or will ever happen with respect to the original sale. Now, if we grant that this type of open-transaction seller realizes gain on the appreciated value of the property upon reacquisition, there can be no reason for not requiring all others to do the same. That another seller perhaps does not fully recover his basis in the year of sale is not relevant to whether he should realize gain on the appreciated value upon reacquisition.

342. In the example given above in the text, the seller's basis was \$50 and he sold for a \$1000 face-amount note payable over ten years. As we have seen, his gain in the year of reacquisition, when the fair market value of the property was \$500, was \$450, if he originally elected to report under section 453. See text accompanying note 315 *supra*. Now assume the fair market value of the purchaser obligation in the year of sale was \$700 and that the seller did not elect under section 453. He would then have a gain of \$650 in the year of sale and a basis of \$700 in the obligation. Accordingly, he has a loss upon the reacquisition of \$200. His total gain on the deal would be \$450, exactly equal to that of the installment method elector. Of course, tremendous economic consequences result from both the timing differences and the limited deductibility of capital losses, but these are policy matters separable from the issue of whether both sellers should realize the same total gain from the appreciation of the property.

343. As discussed earlier, another exception might be justified when eligibility for section 453 is denied solely on the ground of contingencies in the purchaser obligation. See text accompanying notes 247-58 *supra*. However, this exception can be disguised by calling it an open transaction and relying on section 1001 and the prior open-transaction law that has developed thereunder.

Nevertheless, the section 453(d) approach is harsh and incompatible with the reasoning that led to the adoption of section 1038 to cover real property reacquisitions.³⁴⁴ The best solution is to amend section 1038 so that it expressly covers personal property reacquisitions, at least those reacquisitions following casual sales. Failing amendment, however, it would be hard to quibble on equitable grounds with a court that operated on the half-a-loaf principle and gave the benefits of section 1038 by analogy to a personal property seller when the court was not constrained to do otherwise by section 453(d). The question then becomes what effect this judicial rule would have on the fundamental choices involved in reporting gain or loss from the initial sale.

The closed-transaction seller would receive little benefit from such a rule. He has already included the fair market value of the purchaser obligation in the prior year's income. If he repossesses the property, its value will probably be below the prior fair market value of the obligation, and the seller will have a loss in the reacquisition year.³⁴⁵ On the other hand, an open-transaction seller potentially has a great deal to gain. For example, in the case considered above,³⁴⁶ the seller's basis was \$50 and he sold for a ten-year note in the face amount of \$1000, but reacquired the property before any payments were made. If the transaction is considered open, so that the seller has no gain to report in the year of the sale, a reacquisition under the principle of section 1038 simply returns him to his initial position with no gain to report, while the separate-transaction, fair market value rule gives him a gain of \$450. Consequently, judicial adoption of a section-1038-by-analogy rule would place heavy pressure on any seller of highly appreciated personal property to qualify the transaction as open in some way. Particularly if our suggested approach to contingent-price contracts were adopted,³⁴⁷ one could at least conceive of a rash of litigation with results even more confusing and irrational than the current line under section 1001—riddled as it is with irrelevant accounting-method principles and the almost metaphysical concept of ascertainability of fair market value.

Until the problem is solved by amending section 1038 to include reacquisitions of personal property, it is best simply to recommend uni-

344. See notes 320-21 *supra* and accompanying text.

345. Consequently, a complete adoption of section 1038 by analogy would even be detrimental to this seller. Section 1038 bars recognition of loss in addition to limiting the recognition of gain upon reacquisitions. § 1038(a). Because the noninstallment seller of real property is faced with this loss limitation rule, however, the analogy should be complete if it is to be used for personal property at all.

346. See text accompanying note 315 *supra*.

347. See text accompanying notes 247-58 *supra*.

form application of section 453(d)'s fair market value approach. It would help to highlight the problem and thereby encourage prompt congressional action. Further, the problems raised by the alternative may be even worse. In any event, the reacquisition tail should not be permitted to wag the entire sale-of-property dog. The number of reported reacquisition cases is miniscule compared to the number of sales cases. Moreover, reacquisitions pose a problem only in the case of personal property, while the confusion in the general sales area includes all real property transactions as well. Consequently, this loose end in the reacquisition area provides no ground for deviating from the suggested resolution of the tension between the accounting and the sale-or-exchange provisions of the Code.

VII. CONCLUSION

The current statutory scheme is amenable to a coherent and straightforward interpretation of the accounting and sale-or-exchange provisions of the Code. This interpretation comports with the apparent congressional intent, gives meaningful effect to each of the relevant statutory provisions, and permits sound tax planning by providing fairly predictable results. Under the suggested interpretation, all sales of property in the regular course of a business should be accounted for by the taxpayer's method of accounting, except insofar as section 453 is available and is elected. All isolated sales of property, defined as any sales not in the regular course of a business, should be accounted for under section 1001, except insofar as section 453 is available and is elected. Under section 1001, the value of purchaser obligations should normally be considered ascertainable. The only obligations that should be deemed to be without ascertainable fair market value are those for which section 453 is unavailable solely because of a contingency independent of the purchaser's legal obligations under the agreement. While section 453 and section 1038, among other Code sections, can undoubtedly be improved, there is no need to wait for reform before clearing up the current confusion surrounding the interplay of section 1001 and the accounting provisions.