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PLEDGING INSTALLMENT OBLIGATIONS

— by Neil E. Harl*

For some installment sellers, the installment obligation is viewed as an investment asset and is not pledged or assigned unless financial reverses occur.¹ For others, an installment obligation represents economic value to be enjoyed by pledging or assigning the obligation as collateral on a loan or to secure a financial commitment otherwise. Recent legislation has imposed a far more limiting set of rules on using an installment obligation to secure a further economic advantage.²

Effect of disposition of obligations. The privilege of income deferral by installment reporting is generally personal to the party electing the installment method and does not outlast the period during which the obligation is held.³ Sale, gift, or other disposition or satisfaction of an installment obligation results in recognized gain to the taxpayer.⁴

The amount of gain or loss is the difference between the basis of the installment obligation at the time of disposition and either the amount realized in a sale or the fair market value of the obligation at the time it is disposed of other than by sale.⁵ The rules for determining taxable gain on disposition of an installment obligation are different depending upon how the disposition occurs.

- If the disposition is satisfied at other than face value or it is sold or exchanged, the amount to be included in income is the difference between the amount realized and the income tax basis of the obligation.⁶ With this type of disposition, consideration is received.

- If the obligation takes the form of a "distribution, transmission, or disposition otherwise than by sale or exchange," the amount included in income is the difference between the fair market value of the obligation and its income tax basis.⁷

Pledging or assigning obligations. By the IRS view, pledging or assigning installment obligations as security for a loan, substantially equal to the amount of the obligation, constitutes a taxable disposition.⁸ Some courts have agreed.⁹ But the result has been otherwise if the interest rates and maturity dates differ and the taxpayer does not part with a substantial portion of the ownership rights in the obligation.¹⁰

The Internal Revenue Service gained a new weapon in the war on pledgings and assignments in 1987.¹¹ Effective for dispositions after December 17, 1987, in taxable years ending after that date, if any indebtedness is secured by an installment obligation involving property used in the taxpayer's trade or business or held for the production of rental income with a sales price exceeding \$150,000 (*except for personal use property and farm property*), the net proceeds of the secured indebtedness are treated as a payment received on the installment obligation.¹² The payment is considered received as of the later of the time the debt becomes secured or the proceeds of the indebtedness are received by the seller.¹³ The gain recognized, however, cannot exceed the total gain from the installment sale. Receipt by the taxpayer of payments on the installment obligation subsequent to the time of the pledge generally does not result in recognition of additional gain except to the extent that the gain that otherwise would

be recognized on account of the payments exceeds the gain, if any, recognized as a result of the pledge.

For personal use and farm property, and for installment obligations of \$150,000 or less, the 1987 legislation is not applicable.¹⁴ Thus, the pre-1987 IRS position and cases challenging some pledges and assignments continue to be the major source of guidance on whether gain is recognized.¹⁵

Part of the difficulty in working with the 1987 enactment is the uncertainty of the scope of the amendment. The answers to several important questions are far from clear.

- Thus, it is not clear what the consequences would be of pledging partnership interests or S corporation stock where the entity owned an installment obligation; the statute does require that the indebtedness be "directly secured,"¹⁶ indicating that such a pledge might not trigger gain.¹⁷

- For pledges in connection with guarantees, the impact of the 1987 legislation is unclear. Presumably, there is no taxable event until default occurs. Even at that, the outcome is not clear because the guarantor would not have received loan proceeds.

- An argument can be made that unperfected security interests would trigger application of the statute. Thus, the sweep of the statute may extend well beyond formally perfected security interests.

- It is unclear whether a general lien against an installment obligation triggers application of the rule. Moreover, there is no rule for allocating between the pledged obligation and other assets.

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Refinancing indebtedness. Under the statutory rule enacted in 1987, the refinancing of indebtedness outstanding on December 17, 1987, secured by a nondealer real property installment obligation is

treated as a continuation of the indebtedness and does not result in a deemed payment on the obligation.¹⁸ That is the outcome if — (1) the taxpayer is required by the creditor to refinance the loan and

(2) the refinancing is provided by a person other than the creditor or a person related to the creditor.¹⁹

FOOTNOTES

¹ See generally 6 Harl, **Agricultural Law** § 48.03 (1990) for a discussion of installment reporting of gain.

² I.R.C. § 453A(d)(1), added by Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, Sec. 10202(c), 101 Stat. 1330 (1987).

³ See 6 Harl, *supra* note 1, § 48.03[8].

⁴ I.R.C. § 453B(a).

⁵ *Id.*

⁶ I.R.C. § 453B(a)(1).

⁷ I.R.C. § 453B(a)(2). See Rev. Rul. 79-371, 1979-2 C.B. 294.

⁸ See Rev. Rul. 65-185, 1965-2 C.B. 153.

⁹ Joe D. Branham, 51 T.C. 175 (1968); Bogatin v. U.S., 78-2 U.S.T.C. ¶ 9733 (W.D. Tenn. 1978).

¹⁰ Schaeffer v. Comm'r, T.C. Memo. 1981-27; Ltr. Rul. 8711002, Nov. 13, 1987 (pledging of mortgage contract as security for line of credit not disposition of contract where credit line less than amount of contract and secured

creditor not responsible for collection of contract).

¹¹ See note 8 *supra* and accompanying text.

¹² I.R.C. § 453A(d)(1).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ See notes 8-10 *supra* and accompanying text.

¹⁶ I.R.C. § 453A(d)(4).

¹⁷ I.R.C. § 453A.

¹⁸ I.R.C. § 453A(d).

¹⁹ *Id.*

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

AVOIDABLE LIENS. The debtors attempted to avoid a perfected, nonpossessory, nonpurchase-money security interest in household goods. The household goods were exempt, up to a value of \$10,000, under Miss. Code § 85-3-1(1) except as to holders of statutory or voluntary security interests. The court held that because the debtors had voluntarily granted the security interest in their household goods, the household goods were not exempt and the lien against the goods could not be avoided. *In re Fox*, 902 F.2d 411 (5th Cir. 1990).

ELIGIBILITY. An irrevocable trust established to provide a life estate for the settlor with remainders to the settlor's children as part of an estate plan was not eligible for bankruptcy as a business trust because the trust was not established for the purpose of carrying on a business activity. The trust corpus consisted of interests in several businesses of which the other interests were held by other family trusts. *In re Margaret E. DeHoff Trust 1*, 114 B.R. 189 (Bankr. W.D. Mo. 1990).

ESTATE PROPERTY. At the time of filing of the bankruptcy petition, the debtor owned a joint tenancy interest in some

certificates of deposit with her father. Before any action was taken by the trustee, the debtor died and the father claimed the entire proceeds of the certificates as his property. The court held that until the trustee completes action to execute against the joint tenancy property for the bankruptcy estate's share of the property, the joint tenancy is not severed. Thus, upon the death of the debtor, the joint tenancy property passed in total to the other joint tenant. *In re DeMarco*, 114 B.R. 121 (Bankr. N.D. W.Va. 1990).

EXEMPTIONS. The debtor's interest in a profit sharing plan funded with contributions from the debtor's employer were includable in the debtor's estate where the debtor could receive all of the funds upon termination of employment. The trustee also acquired the debtor's right to compel lump sum distribution of the amounts in the plan upon termination of the debtor's employment. The debtor was not allowed an exemption for the debtor's interest in the plan under Mo. Rev. Stat. § 513.427 because the statute was preempted by ERISA and ERISA was not a non-bankruptcy federal exemption. *In re Schmitt*, 113 B.R. 1007 (Bankr. W.D. Mo. 1990).

The debtor's interest in a retirement plan which qualified under ERISA was held to be exempt property under ERISA as a federal exemption. The Texas exemption for ERISA qualified plans was held to be pre-

empted by ERISA. *In re Felts*, 114 B.R. 131 (Bankr. W.D. Tex. 1990).

The debtor's interest in an IRA was held includable in the bankruptcy estate and not eligible for an exemption under Oklahoma law. *In re Ree*, 114 B.R. 286 (Bankr. N.D. Okla. 1990).

CHAPTER 11

PLAN. The debtors' Chapter 11 plan provided for the deeding of 131 acres of farm land back to the secured creditors holding a lien against a total of 700 acres of the debtors' land in return for a credit against the amount owed to the creditors. The court held that this part of the plan was fair and equitable under Section 1129(b)(2). The land to be deeded back was valued at its liquidation value less the costs of sale, even though the land was contiguous to land already owned by the creditors. *In re Simons*, 113 B.R. 942 (Bankr. W.D. Tex. 1990).

CHAPTER 12

DISPOSABLE INCOME. In this consolidated ruling involving two Chapter 12 cases, the debtors had completed their Chapter 12 plan payments and had petitioned for discharge. The trustee and unsecured creditors objected because the debtors had retained from the income of the last year of the plans sufficient amounts to plant and harvest the crops for the year after