WHEN A CONTRACT OBLIGOR BECOMES AN OWNER OF THE CONTRACT

— by Neil E. Harl*

A contract for deed or installment contract for the sale of real estate (or other assets) between parent and child is not unusual; a frequent outcome of such transactions is that the obligor under the contract becomes the owner or a co-owner of the contract after death of the contract seller which results in often unanticipated income tax consequences.2

Effect of death of contract seller

For installment obligations held until death, the fair market value of the obligation is included in the decedent’s gross estate for federal estate tax purposes.7 The value of the installment obligation may not be reduced by the estimated amount of income tax payable on installments remaining to be paid8 although courts have permitted a discount in valuing corporate stock for potential income tax liability on liquidation even though liquidation is not contemplated.5 A deduction is permitted to each recipient of income in respect of decedent equal to the federal estate tax attributable to the obligation.6

For a beneficiary who is not the obligor, the decedent’s estate is not charged with inclusion of the potential income from an installment sale obligation as a result of distribution of the obligation which was entered into before the death of the decedent as seller.7 The income tax basis of the obligation in the hands of the beneficiary is the decedent’s basis, adjusted for installments received by the estate (and the decedent) before distribution to the beneficiary.8 The beneficiary continues to report payments in the same manner as the decedent would have done had the decedent survived.9

Disposition of contract to obligor

For deaths before October 20, 1980, different theories had been utilized to determine the income tax treatment of installment obligations passing to the obligor at the death of the contract seller.10 However, Congress in the Installment Sales Act of 1980,11 addressed the issue and provided that disposition of an installment obligation to the obligor after October 19, 1980, results in recognition of any unreported gain to the deceased seller’s estate.12 The same treatment applies to installment obligations cancelled at death.13 In a 1990 private letter ruling,14 an installment note (the gain from which the decedent had been reporting in installments) from an heir to the decedent was cancelled; IRS ruled that the remainder of the gain on the installment sale was included in income to the decedent’s estate.15 That is the outcome whether

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the disposition of the installment obligation is by bequest, devise or inheritance by the obligor or by cancellation by the estate representative. Unless there is some act of cancellation of the obligation, the disposition is considered to have occurred no later than the conclusion of administration of the estate. For obligations held by a person other than the decedent, such as a trust, the cancellation is treated as a transfer immediately after the decedent’s death by that person.

Presumably, disposition of an installment obligation to two or more persons, one of whom is the obligor, results in a taxable disposition to the extent of the obligor’s interest acquired in the installment obligation. To avoid that result, the decedent could dispose of the installment obligation to the other heirs (who are not obligors under the installment obligation) with other property passing to the obligor.

Installment sale by the estate

For installment sale obligations entered into by the administrator or executor on behalf of the estate, distribution of the installment sale obligation from the estate constitutes a taxable disposition by the estate. A statutory provision shields from recognition of gain amounts with respect to property under special use valuation and then only to the extent the fair market value at death or the alternate valuation date exceeds the special use value and then only if the transfer is to a qualified heir. The exception in I.R.C. § 453B(c), for “transmission of installment obligations at death,” does not apply to installment obligations entered into by the estate inasmuch as the distribution of installment obligations entered into by an estate would not involve “the transmission of installment obligations at death.”

In conclusion

The disposition of installment obligations at death deserves careful planning attention before death of the seller under the obligation if deferral of recognition of gain is to be assured under income in respect of decedent rules.

FOOTNOTES

2. See I.R.C. § 691(a).
3. I.R.C. § 2031(a).

8. See 6 Harl, supra note 1, § 48.03[8][b][ii].
10. See Jack Ammann Photogrammetric Engineers, Inc. v. Comm’r, 341 F.2d 466 (5th Cir. 1965) (no income tax obligation on merger of obligor and obligee of installment obligation); Wilkinson v. Comm’r, 49 T.C. 4 (1967) (merger of obligor and obligee under installment sale obligation was taxable disposition to taxpayers).
15. Id.
17. Id. at 23.
22. I.R.C. § 453B(c).
23. I.R.C. § 691(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].

AUTOMATIC STAY. The debtor was a partnership and the partners had filed a Tax Court case seeking readjustment of a final partnership administrative adjustment. The partners sought a stay of the Tax Court proceedings, based on the automatic stay in bankruptcy. The court held that the debtor was not involved in the Tax Court proceeding because the debtor was not a taxed entity and had no assets subject to the partners’ claims in bankruptcy. The court held that the partners’ Tax Court case was not stayed by the partnership’s bankruptcy case. In re Madison Recycling Assoc., 2002-2 U.S. Tax Cas.