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## INTEREST RATES ON INSTALLMENT SALES

— by Neil E. Harl\*

Since 1964, a minimum interest rate has been imposed on installment sales.<sup>1</sup> More precisely, a part of each principal payment under an installment sale is treated as interest rather than sales price (and the total sales price is correspondingly reduced) if interest of less than the prescribed rate is specified.<sup>2</sup>

**Rates before 1985.** From 1964 to 1985, the minimum interest rate rules reflected the rising level of interest rates in the U.S. economy.<sup>3</sup>

- For obligations entered into on or before July 24, 1975, the applicable "test rate"—the minimum acceptable rate—was four percent; if no interest or a rate less than four percent was used in a contract, the "unstated" interest to be reported was computed at five percent compounded semiannually.<sup>4</sup>

- For installment obligations entered into on or after July 24, 1975, and before July 1, 1981, the test rate was six percent and unstated interest was to be reported at seven percent compounded semiannually.<sup>5</sup>

- Effective for obligations entered into on or after July 1, 1981, and before 1985, the test rate was nine percent and unstated interest was to be reported at 10 percent compounded semiannually.<sup>6</sup> The rate change had been proposed by IRS for obligations entered into on or after September 29, 1980.<sup>7</sup> However, the effective date was delayed until July 1, 1981.<sup>8</sup>

- The test rate under a 1984 law, to be effective in 1985, was set at 110 percent of the applicable federal rate.<sup>9</sup> If interest was not stated at least at the test rate, interest was imputed at a rate of 120 percent of the applicable federal rate compounded semiannually. However, effective after December 31, 1984, and before July 1, 1985, the test rate of nine percent, and the imputed rate of 10 percent, were continued for borrowed amounts of \$2,000,000 or less.<sup>10</sup> These rules applicable in the years before mid 1985 are important; if there is a substantial change in the terms of obligations entered into during those periods, the *current* rules on minimum interest rates apply.<sup>11</sup> Thus, any restructuring of contracts as for back as the days of four percent interest could require application of current minimum interest rules.

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**Rates after mid-1985.** Under a 1985 amendment, the test rate to be applied is dependent upon the amount of seller financing involved and the concept of a higher imputed rate was dropped.<sup>12</sup> Where the amount of seller financing is \$3,079,600 or less (for 1991), under the general rule the test rate is the lesser of nine percent or the Applicable Federal Rate (AFR).<sup>13</sup> The threshold amount is indexed for inflation. If the amount of seller financing is more than \$3,079,600 (for 1991), the test rate is 100 percent of the AFR.<sup>14</sup>

The AFR is based on the average yield on federal debt obligations of similar maturity.<sup>15</sup> The rates are published on a monthly basis and are published in *Agricultural Law Digest* each month. The short-term rate is for obligations with a term not more than three years, the mid-term rate is for obligations with a term over three years but not more than nine years and the long term rate is for obligations with a term of more than nine years.<sup>16</sup> The federal rate is the lowest of the AFR's in effect for any month in the three month period ending with the first calendar month in which there is a binding contract in writing for the sale or exchange.<sup>17</sup>

In general, both buyer and seller are required to account for the interest in seller-financed transactions under the accrual method of accounting.<sup>18</sup> However, if the amount of seller financing is \$2,199,700 or less (for 1991), both parties may elect to account for interest under the cash method of accounting.<sup>19</sup> The figure is indexed for inflation.<sup>20</sup> The election to report interest on the cash method of accounting is not available to dealers or those on the accrual method of accounting.<sup>21</sup> If the election to use the cash method is made, and the seller transfers the buyer's obligation to a third party, the transferee reports interest in accordance with cash accounting.<sup>22</sup> However, a transfer to a taxpayer on the accrual method of accounting eliminates the special cash method reporting.<sup>23</sup>

**Special exceptions.** For owners of farm and ranch property, the most important exception involves the sale of "land between family members up to \$500,000 per year by a seller to a buyer."<sup>24</sup> Such sales are subject to a six percent minimum interest rate compounded semiannually.<sup>25</sup> For this purpose, "member of family" is defined to include brothers and sisters, spouse, ancestors and lineal descendants.<sup>26</sup> Thus, care should be exercised to insure that non-family members (such as spouses of children) are not

included as buyers in the transaction if interest of less than the regular rate is to be used.

It is important to note that using the six percent rate for sales of land within the family runs the risk of a gift as to the present value of the difference between the rate used and a market rate of interest.<sup>27</sup>

The sale of a "farm" is not subject to the original issue discount rules if the sale is for less than \$1 million.<sup>28</sup> However, that provision does not apply to "cash method debt instruments" if the stated principal amount does not exceed \$2,199,700 (for 1991), the lender is not a dealer and the lender is not on the accrual method of accounting.<sup>29</sup>

#### FOOTNOTES

- <sup>1</sup> Pub. L. 88-272, 88th Cong., 2d Sess., Sec. 224(a).  
<sup>2</sup> I.R.C. § 483. See generally 6 Harl, **Agricultural Law** § 48.03[7] (1991).  
<sup>3</sup> See 6 Harl, *supra* note 2, § 48.03[7][a].  
<sup>4</sup> Treas. Reg. § 1.483-1(c)(2)(ii)(A).  
<sup>5</sup> Treas. Reg. § 1.483-1(c)(2)(ii)(B).  
<sup>6</sup> Treas. Reg. §§ 1.483-1(c)(2)(ii)(C); 1.483-1(d)(1)(ii)(C).  
<sup>7</sup> 45 Fed. Reg. 57739, Aug. 29, 1980.  
<sup>8</sup> IR 81-45, April 27, 1981. See T.D. 7781, 46 Fed. Reg. 34567, July 1, 1981.  
<sup>9</sup> I.R.C. §§ 483(b)(1)(B), 1274(c)(3).  
<sup>10</sup> Pub. L. 98-612, Sec. 2, 98 Stat. 3182 (1984).  
<sup>11</sup> See Treas. Reg. § 1.483-1(c)(4).  
<sup>12</sup> Pub. L. 99-121, 99 Stat. 505 (1985).  
<sup>13</sup> I.R.C. § 1274A.  
<sup>14</sup> I.R.C. § 1274; Rev. Proc. 91-11, I.R.B. 1991-6, 12.  
<sup>15</sup> I.R.C. § 1274(d).  
<sup>16</sup> *Id.*  
<sup>17</sup> I.R.C. § 1274(d)(2).  
<sup>18</sup> See I.R.C. §§ 1272, 1274.  
<sup>19</sup> I.R.C. § 1274A(c); Rev. Proc. 91-11, I.R.B. 1991-6, 7.  
<sup>20</sup> I.R.C. § 1274A(d)(2).  
<sup>21</sup> I.R.C. § 1274A(c)(2)(B).  
<sup>22</sup> I.R.C. § 1274A(c)(3)(A).  
<sup>23</sup> I.R.C. § 1274A(c)(3)(B).  
<sup>24</sup> I.R.C. § 483(e).  
<sup>25</sup> *Id.*  
<sup>26</sup> I.R.C. §§ 483(e)(2), 267(c)(4).  
<sup>27</sup> *Krabbenhof v. Comm'r*, 94 T.C. No. 56 (1990), *aff'd* \_\_\_ F.2d \_\_\_ (8th Cir. 1991) (farmland sold to sons at six percent interest; IRS used 11 percent interest to calculate gift); Ltr. Rul. 8804002, Sept. 3, 1987; Ltr. Rul. 8512002, Nov. 28, 1984. But see *Ballard v. Comm'r*, T.C. Memo. 1987-128, *rev'd*, 854 F.2d 185 (7th Cir. 1988) (sale of property at below market interest rate was not gift to extent interest rate below market rate).  
<sup>28</sup> I.R.C. § 1274(c)(3)(A).  
<sup>29</sup> I.R.C. § 1274A(c)(2).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### ADVERSE POSSESSION

**CONTINUOUS POSSESSION.** The dispute involved two lots which were included in the legal description of the plaintiff's title but which were used by the defendant, either as tenant or as landlord. The defendant farmed the lots for rice crops every third year and used the lots for pasturing cattle in the fallow years. The lots were enclosed only as part of a larger common enclosure. The court held that such activity was insufficient to support continuous adverse possession of the lots. The lots were also later leased to a third party who completely enclosed the lots and used them for seven years to pasture cattle. After that time, the plaintiff asserted ownership over the lots by erecting fences around the lots, and the defendant asserted ownership by tearing down the fences. The court held that the defendant did not have continuous possession over the lots for the requisite 10 years during this period. **Parker v. McGinnes**, 809 S.W.2d 752 (Tex. Ct. App. 1991).

### BANKRUPTCY

#### GENERAL

**AUTOMATIC STAY.** As part of their Chapter 11 plan, the debtors had reached a settlement agreement with a secured creditor for payment of the secured debt with the deed

to the secured property farm land being held in escrow and subject to forfeiture of the property in the case of default on plan payments. After the debtors defaulted on plan payments, the creditor petitioned for lifting of the automatic stay to allow transfer of the deed from escrow. The court held that default of plan payments was sufficient cause to lift the automatic stay. **In re Wieseler**, 934 F.2d 965 (8th Cir. 1991).

**EXEMPTIONS.** Prior to filing bankruptcy, the debtor used non-exempt property to purchase an exempt interest in an annuity. The District Court held that the annuity was exempt where the Bankruptcy Court had found no extrinsic evidence of fraud against creditors from the purchase of the annuity. **Matter of Armstrong**, 127 B.R. 852 (D. Neb. 1989), *aff'd* 93 B.R. 197 (Bankr. D. Neb. 1988). The case was affirmed at 931 F.2d 1233 (8th Cir. 1991) see p. 123 *supra*.

**SECURED CLAIMS.** Under an agreement with the debtors, the FmHA made a Section 1111(b) election to have the real and personal property collateral secure all secured claims against the debtors. However, the debtors' Chapter 11 plan omitted the personal property collateral from the Section 1111(b) election. In taking advantage of this omission, the debtors proposed to sell the personal property in satisfaction of the debts secured by the property. The