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## GOOD NEWS AND BAD NEWS FOR INSTALLMENT REPORTING BY ACCRUAL ACCOUNTING TAXPAYERS

— by Neil E. Harl\*

In one of the great ironies of the age, on the very day President Clinton signed the widely criticized near-ban on installment reporting of gain by taxpayers on the accrual method of accounting,<sup>1</sup> December 28, 2000, the U.S. Tax Court delivered more bad news on installment reporting of gain to accrual accounting taxpayers.<sup>2</sup> If not reversed on appeal, the Tax Court decision could promise to be a barrier to installment. Certainly, the Tax Court decision is a more serious problem for taxpayers disposing of property “used or produced in the business of farming.”<sup>3</sup>

### The statutory ban

In legislation effective on December 17, 1999, the Congress passed a ban on installment reporting of gain for taxpayers “on an accrual method of accounting” with three enumerated exceptions for gain from—(1) residential lots; (2) timeshares; and (3) the disposition of any property “used or produced in the trade or business of farming....”<sup>4</sup> It was believed that the farming exception meant that an accrual accounting landlord could use installment reporting of gain for eligible capital assets or assets used in the business provided the assets were “used or produced” under a crop share or livestock share lease with substantial involvement in management.<sup>5</sup> Whether such a landlord could use installment reporting for the sale of farm commodities<sup>6</sup> turned on whether the accrual accounting landlord was required to report the commodities in inventory<sup>7</sup> which presumably would be the case for someone on classic accrual accounting.<sup>8</sup> If inventories were being used, eligibility for installment reporting of commodities would be denied; however, if the taxpayer was using a hybrid method of accounting<sup>9</sup> which did not involve inventories, installment reporting would be available.

As noted above,<sup>10</sup> the repeal of the statutory ban on installment reporting of gain by taxpayers on an accrual method of accounting was signed by President Clinton on December 28, 2000.<sup>11</sup>

### *Keith v. Comm’r*

On the same day, December 28, 2000, the U.S. Tax Court decided a case, *Keith v. Comm’r*,<sup>12</sup> which involved the sale of residential real property sold under installment contract. Under the contract, the buyers obtained possession; paid the property taxes, insurance and maintenance; and were obligated to make monthly payments, with interest, toward the purchase price. After making full payment, the buyers would receive a warranty deed. If default occurred, the contracts would be voided and amounts paid would be retained as liquidated damages. The

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See the back page for details about the  
**2001 Agricultural Tax and Law Seminars**  
by Dr. Neil Harl and Prof. Roger McEowen

court concluded that the transaction produced income in the year of sale with the sale deemed completed in the year of contract execution for the seller which was on the accrual method of accounting.<sup>13</sup> The Tax Court pointed out that the seller only had a security interest in the property.

Interestingly, the Tax Court acknowledged that the seller did not argue that the statutory authority for installment reporting of gain, I.R.C. § 453, applied.<sup>14</sup> That may have been because of the dealer exception to the statutory authority for installment reporting,<sup>15</sup> which arguably would have applied.

The Tax Court specifically noted that its 1967 decision, *Baertschi v. Comm'r*,<sup>16</sup> would no longer be followed.<sup>17</sup> That case had been reversed by the Sixth Circuit Court of Appeals in 1969.<sup>18</sup> In the Tax Court decision in *Baertschi v. Comm'r*,<sup>19</sup> the taxpayers had entered into an installment contract for the sale of a residence. The issue was whether the taxpayers were eligible for the rollover of gain under I.R.C. § 1034 (which was repealed in 1997). The Tax Court held that the contract did not constitute a "sale" of the property on the date entered into for purposes of the then-available statutory rollover of gain by reinvestment in a replacement residence. The Tax Court held that "sale" occurred later when final payment was made on the contract.<sup>20</sup> Thus, the gain was eligible for rollover treatment. Five Tax Court judges dissented from the majority opinion in the court-reviewed decision.<sup>21</sup>

The Sixth Circuit Court of Appeals, however, reversed the Tax Court<sup>22</sup> and held that the sale transaction was consummated on the date benefits and burdens of ownership had passed to the buyers and the buyers had paid a substantial part of the sales price.<sup>23</sup> The sellers at that point had "absolute right to title on payment of the full purchase price."<sup>24</sup> Accordingly, the taxpayers were not eligible for the rollover of gain inasmuch as they did not occupy the replacement property within 18 months, the statutory period at that time.

**In conclusion**

The Tax Court took the position, under the facts of the case of *Keith v. Comm'r*, that sale was consummated and income tax was properly imposed on the transaction in the year of contract execution.<sup>25</sup> The decision leaves open an obvious question: is the opinion limited to accrual accounting taxpayers? Arguably, it is so limited. Certainly, I.R.C. § 453 constitutes clear authority for installment reporting of gain. An argument can be made that, with repeal of the ban on installment reporting by those on accrual accounting,<sup>26</sup> Congress intended for accrual taxpayers to be eligible for installment reporting as well.

Unfortunately, the application of I.R.C. § 453 was not argued in *Keith v. Comm'r*.<sup>27</sup> If the *Keith* decision is limited to dealer reporting, the impact is likely to be modest.

**FOOTNOTES**

- 1 Installment Sale Correction Bill, H.R. 3594, 106th Cong., 2d Sess. (2000), *repealing* Pub. L. 106-170, Sec. 536, 106th Cong., 1st Sess. (1999), amending I.R.C. § 453(a)(2). See generally, 6 Harl, *Agricultural Law* § 48.03 (2000); Harl, *Agricultural Law Manual* § 6.03[1] (2000). See also Harl, "New Limits on Installment Reporting" 11 *Agric. L. Dig.* 9 (2000).
- 2 *Keith v. Comm'r*, 115 T.C. No. 42 (2000).
- 3 See I.R.C. § 453(a), (l)(2)(A), added by Pub. L. 106-170, 106th Cong., 1st Sess. (1999).
- 4 I.R.C. § 453(a), (l)(2)(A), (B).
- 5 See Harl, "New Limits on Installment Reporting" 11 *Agric. L. Dig.* 9 (2000).
- 6 I.R.C. § 453(b)(2)(B). See 4 Harl, *Agricultural Law* § 25.03[2] (2000).
- 7 *Id.*
- 8 See 4 Harl, *supra* note 6, § 25.03[2].
- 9 See 4 Harl, *supra* note 6 § 25.03[3].
- 10 See note 1 *supra*.
- 11 H.R. 3594, 106th Cong., 2d Sess. (2000).
- 12 115 T.C. No. 42 (2000).
- 13 *Id.*
- 14 *Id.*
- 15 See I.R.C. § 453(b)(2)(A).
- 16 49 T.C. 289 (1967).
- 17 *Keith v. Comm'r*, 115 T.C. No. 42 (2000).
- 18 *Baertschi v. Comm'r*, 412 F.2d 494 (6th Cir. 1969), *rev'g*, 49 T.C. 289 (1967).
- 19 49 T.C. 289 (1967).
- 20 *Id.*
- 21 *Id.*
- 22 *Baertschi v. Comm'r*, 412 F.2d 494 (6th Cir. 1969), *rev'g*, 49 T.C. 289 (1967).
- 23 *Id.*
- 24 *Id.*
- 25 *Keith v. Comm'r*, 115 T.C. No. 42 (2000).
- 26 H.R. 3594, 106th Cong., 2d Sess. (2000).
- 27 115 T.C. No. 42 (2000).

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## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

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### BANKRUPTCY

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**FEDERAL TAX-ALM § 13.03[7].\***

**DISCHARGE.** The debtor owed taxes for 1987, 1988 and 1989 and filed for bankruptcy in August 1990. That case was dismissed in October 1994 and the current case was filed in January 1995. The debtor sought to discharge all of the taxes as

taxes assessed more than three years before the filing of the petition in the current case. The previous hearings in this case held that the filing of a bankruptcy petition did not toll the three year period of Section 507(a)(8)(A)(i); however, the 11th Circuit Court of Appeals remanded the case, holding that the Bankruptcy Court could exercise its equitable powers to toll the three year period. The court held that the 1987 and 1988 taxes were dischargeable because the IRS had sufficient time to assess and collect those taxes before the filing of the first bankruptcy

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\**Agricultural Law Manual* (ALM).