Standard Federal Income Tax Reporter (2011), Regulation, §15A.453-1.Installment method reporting for sales of real property and casual sales of personal property (Temporary)

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Temporary Reg. § 15A.453-1 does not reflect recent law changes. For details, see ¶21,404.01.

(a)*In general.—* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method.

(b)*Installment sale defined*

(1)*In general.—* The term "installment sale" means a disposition of property (except as provided in paragraph (b)(4) of this section) where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term "installment sale" includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. For purposes of this paragraph, the taxable year in which payments are to be received is to be determined without regard to section 453(e) (relating to related party sales), section (f)(3) (relating to the definition of a "payment") and section (g) (relating to sales of depreciable property to a spouse or 80-percent-owned entity).

(2)*Installment method defined*

(i)*In general.—* Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the "gross profit ratio"). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(ii)*Selling price defined.—* The term "selling price" means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price. See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iii)*Contract price defined.—* The term "contract price" means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted, for installment sales in taxable years ending after October 19, 1980, to reflect commissions and other selling expenses as provided in paragraph (b)(2)(v) of this section). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iv)*Qualifying indebtedness.—* The term "qualifying indebtedness" means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. The term "qualifying indebtedness" does not include an obligation of the taxpayer incurred incident to the disposition of the property (*e.g.,* legal fees relating to the taxpayer's sale of the property) or an obligation functionally unrelated to the acquisition, holding, or operating of the property (*e.g.,* the taxpayer's medical bill). Any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.

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(v)*Gross profit defined.—* The term "gross profit" means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. Such additions to basis will not be deemed to affect the taxpayer's holding period in the transferred property.

(3)*Payment*

(i)*In general.—* Except as provided in paragraph (e) of this section (relating to purchaser evidences of indebtedness payable on demand or readily tradable), the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property ("installment obligation"), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency). For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see §§ 1.1031(b)-2(b) and 1.1031(k)-1(j)(2)(iii) of this chapter. A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include amounts actually or constructively received in the taxable year under an installment obligation. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)-1(j)(2)(ii) of this chapter. Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see § 1.1031(k)-1(j)(2)(i) of this chapter. Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences of indebtedness which are payable on demand or readily tradable. However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph (f) of this section (relating to transactions described in sections 351, 356(a) and 1031). Except as provided in § 15A.453-2 of these regulations (relating to distributions of installment obligations in corporate liquidations described in section 337), payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section) assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property (determined after adjustment to reflect selling expenses). For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (*e.g.,* a novation) shall be treated as an assumption of the qualifying indebtedness. If the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment. To the extent that cancellation is not in consideration of the sale, see §§ 1.61-12(b)(1) and 1.1001-2(a)(2) relating to discharges of indebtedness. If the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.

(ii)*Wrap-around mortgage.—* This paragraph (b)(3)(ii) shall apply generally to any installment sale after March 4, 1981 unless the installment sale was completed before June 1, 1981 pursuant to a written obligation binding on the seller that was executed on or before March 4, 1981. A "wrap-around mortgage" means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property ("wrapped indebtedness") and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments

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on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. For purposes of this paragraph (b)(3)(ii), the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale. Therefore, except as otherwise required by section 483 or 1232, the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

(iii)*Standby letter of credit.*— The term "standby letter of credit" means a non-negotiable, nontransferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Whether or not the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

(4)*Exceptions.*— The term "installment sale" does not include, and the provisions of section 453 do not apply to, dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan, or to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year. See section 453A and the regulations thereunder for rules relating to installment sales by dealers in personal property. A dealer in real property or a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.

(5)*Examples.*— The following examples illustrate installment method reporting under this section:

Example (1). In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for $100,000: $10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is $38,000. Selling expenses paid by A are $2,000. Therefore, the gross profit is $60,000 ($100,000 selling price # $40,000 basis inclusive of selling expenses). The gross profit ratio is 3/5 (gross profit of $60,000 divided by $100,000 contract price). Accordingly, $6,000 (3/5 of $10,000) of each $10,000 payment received is gain attributable to the sale and $4,000 ($10,000 # $6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.

Example (2). C sells Whiteacre to D for a selling price of $160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of $60,000. D will assume or take subject to the $60,000 mortgage and pay the remaining $100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is $90,000. There are no selling expenses. The contract price is $100,000, the $160,000 selling price reduced by the mortgage of $60,000 assumed or taken subject to. Gross profit is $70,000 ($160,000 selling price less C's basis of $90,000). C's gross profit ratio is 7/10 (gross profit of $70,000 divided by $100,000 contract price). Thus, $7,000 (7/10 of $10,000) of each $10,000 annual payment is gain attributable to the sale, and $3,000 ($10,000 # $7,000) is recovery of basis.

Example (3). The facts are the same as in example (2), except that C's basis in the land is $40,000. In the year of the sale C is deemed to have received payment of $20,000 ($60,000 # $40,000, the amount by which the mortgage D assumed or took subject to exceeds C's basis). Since basis is fully recovered in the year of sale, the gross profit ratio is 1 ($120,000/$120,000) and C will report

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100% of the $20,000 deemed payment in the year of sale and each $10,000 annual payment as gain attributable to the sale.

Example (4). E sells Blackacre, an unencumbered capital gain property in E's hands, to F on January 2, 1981. F makes a cash down payment of $500,000 and issues a note to E obliging F to pay an additional $500,000 on the fifth anniversary date. The note does not require a payment of interest. In determining selling price, section 483 will apply to recharacterize as interest a portion of the $500,000 future payment. Assume that under section 483 and the applicable regulations $193,045 is treated as total unstated interest, and the selling price is $806,955 ($1 million less unstated interest). Assuming E's basis (including selling expenses) in Blackacre is $200,000, gross profit is $606,955 ($806,955 # $200,000) and the gross profit ratio is 75.21547%. Accordingly, of the $500,000 cash down payment received by E in 1981, $376,077 (75.21547% of $500,000) is gain attributable to the sale and $123,923 is recovery of basis ($500,000 # $376,077).

Example (5). In 1982, G sells to H Blackacre, which is encumbered by a first mortgage with a principal amount of $500,000 and a second mortgage with a principal amount of $400,000, for a selling price of $2 million. G's basis in Blackacre is $700,000. Under the agreement between G and H, passage of title is deferred and H does not assume and purportedly does not take subject to either mortgage in the year of sale. H pays G $200,000 in cash and issues a wrap-around mortgage note with a principal amount of $1,800,000 bearing adequate stated interest. H is deemed to have acquired Blackacre subject to the first and second mortgages (wrapped indebtedness) totalling $900,000. The contract price is $1,300,000 (selling price of $2 million less $700,000 mortgages within the seller's basis assumed or taken subject to). Gross profit is also $1,300,000 (selling price of $2 million less $700,000 basis). Accordingly in the year of sale, the gross profit ratio is 1 ($1,300,000/$1,300,000). Payment in the year of sale is $400,000 ($200,000 cash received plus $200,000 mortgage in excess of basis ($900,000 # $700,000)). Therefore, Grecognizes $400,000 gain in the year of sale ($400,000 × 1). In the hands of G the wrap-around installment obligation has a basis of $900,000, equal to G's basis in Blackacre ($700,000) increased by the gain recognized by G in the year of sale ($400,000) reduced by the cash received by G in the year of sale ($200,000). G's gross profit with respect to the note is $900,000 ($1,800,000 face amount less $900,000 basis in the note) and G's contract price with respect to the note is its face amount of $1,800,000. Therefore, the gross profit ratio with respect to the note is ½ ($900,000/$1,800,000).

Example (6). The facts are the same as example (5) except that under the terms of the agreement H assumes the $500,000 first mortgage on Blackacre. H does not assume and purportedly does not take subject to the $400,000 second mortgage on Blackacre. The wrap-around installment obligation issued by H to G has a face amount of $1,300,000. The tax results in the year of sale to G are the same as example (5) ($400,000 payment received and gain recognized). In the hands of G, basis in the wrap-around installment obligation is $400,000 ($700,000 basis in Blackacre plus $400,000 gain recognized in the year of sale minus $700,000 ($200,000 cash received and $500,000 treated as cash received as a result of H's assumption of the first mortgage)). G's gross profit with respect to the note is $900,000 ($1,300,000 face amount of the wrap-around installment obligation less $400,000 basis in that note) and G's contract price with respect to the note is its face value of $1,300,000. Therefore, the gross profit ratio with respect to the note is 9/13

$$\left(\frac{\$\,900{,}000}{\$1{,}300{,}000}\right).$$

Example (7). A sells the stock of X corporation to B for a $1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit (within the meaning of paragraph (b)(3)(iii) of this section) issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct lien upon or other security interest in such cash or cash equivalent collateral. Receipt of B's installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

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Example (8). The facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of $600,000. To secure fully its $1 million note issued to A, B deposits in escrow $400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B's installment obligation will be treated as the receipt payment by A in the sum of $400,000.

(c)*Contingent payment sales*

(1)*In general.—* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, contingent payment sales are to be reported on the installment method. As used in this section, the term "contingent payment sale" means a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.

The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term. See paragraph (c)(8) of this section, describing the extent to which the regulations under section 385 apply to the determination of whether an installment obligation represents an equity interest in a corporation.

This paragraph prescribes the rules to be applied in allocating the taxpayer's basis (including selling expenses except for selling expenses of dealers in real estate) to payments received and to be received in a contingent payment sale. The rules are designed appropriately to distinguish contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable. In addition, rules are prescribed under which, in appropriate circumstances, the taxpayer will be permitted to recover basis under an income forecast computation.

(2)*Stated maximum selling price*

(i)*In general*

(A) A contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. Except as provided in paragraph (c)(2)(ii) and (7) of this section (relating to certain payment recomputations), the taxpayer's basis shall be allocated to payments received and to be received under a stated maximum selling price agreement by treating the stated maximum selling price as the selling price for purposes of paragraph (b) of this section. The stated maximum selling price, as initially determined, shall thereafter be treated as the selling price unless and until that maximum amount is reduced, whether pursuant to the terms of the original agreement, by subsequent amendment, by application of the payment recharacterization rule (described in paragraph (c)(2)(ii) of this section), or by a subsequent supervening event such as bankruptcy of the obligor. When the maximum amount is subsequently reduced, the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which an event requiring reduction occurs. If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(B) The following examples illustrate the provisions of paragraph (c)(2)(i) of this section. In each example, it is assumed that application of the rules illustrated will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

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Example (1). A sells all of the stock of X corporation to B for $100,000 payable at closing plus an amount equal to 5% of the net profits of X for each of the next nine years, the contingent payments to be made annually together with adequate stated interest. The agreement provides that the maximum amount A may receive, inclusive of the $100,000 down payment but exclusive of interest, shall be $2,000,000. A's basis in the stock of X inclusive of selling expenses, is $200,000. Selling price and contract price are considered to be $2,000,000. Gross profit is $1,800,000, and the gross profit ratio is 9/10 ($1,800,000/$2,000,000). Accordingly, of the $100,000 received by A in the year of sale, $90,000 is reportable as gain attributable to the sale and $10,000 is recovery of basis.

Example (2). C owns Blackacre which is encumbered by a long-standing mortgage of $100,000. On January 15, 1981, C sells Blackacre to D under the following payment arrangement: $100,000 in cash on closing; nine equal annual installment payments of $100,000 commencing January 15, 1982; and nine annual payments (the first to be made on March 30, 1982) equal to 5% of the gross annual rental receipts from Blackacre generated during the preceding calendar year. The agreement provides that each deferred payment shall be accompanied by a payment of interest calculated at the rate of 12% per annum and that the maximum amount payable to C under the agreement (exclusive of interest) shall be $2,100,000. The agreement also specifies that D will assume the long-standing mortgage. C's basis (inclusive of selling expenses) in Blackacre is $300,000. Accordingly, selling price is $2,100,000 and contract price is $2,000,000 (selling price of $2,100,000 less the $100,000 mortgage). The gross profit ratio is 9/10 (gross profit of $1,800,000 divided by $2,000,000 contract price). Of the $100,000 cash payment received by C in 1981, $90,000 is gain attributable to the sale of Blackacre and $10,000 is recovery of basis.

(ii)*Certain interest recomputations.—* When interest is stated in the contingent price sale agreement at a rate equal to or greater than the applicable prescribed test rate referred to in § 1.483-1(d)(1)(ii) and such stated interest is payable in addition to the amounts otherwise payable under the agreement, such stated interest is not considered a part of the selling price. In other circumstances (i.e., section 483 is applicable because no interest is stated or interest is stated below the applicable test rate, or interest is stated under a payment recharacterization provision of the sale agreement), the special rule set forth in this (ii) shall be applied in the initial computation and subsequent recomputations of selling price, contract price, and gross profit ratio. The special rule is referred to in this section as the "price-interest recomputation rule." As used in this section, the term "payment recharacterization" refers to a contractual arrangement under which a computed amount otherwise payable as part of the selling price is denominated an interest payment. The amount of unstated interest determined under section 483 or (if section 483 is inapplicable in the particular case) the amount of interest determined under a payment recharacterization arrangement is collectively referred to in this section as "internal interest" amounts. The price-interest recomputation rule is applicable to any stated maximum selling price agreement which contemplates receipt of internal interest by the taxpayer. Under the rule, stated maximum selling price will be determined as of the end of the taxpayer's taxable year in which the sale or other disposition occurs, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates permitted under the agreement. With respect to the year of sale, the amount (if any) of internal interest then shall be determined taking account of the respective components of that calculation. The maximum amount initially calculated, minus the internal interest so determined, is the initial stated maximum selling price under the price-interest recomputation rule. For each subsequent taxable year, stated maximum selling price (and thus selling price, contract price, and gross profit ratio) shall be recomputed, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates permitted under the agreement. The redetermined gross profit ratio, adjusted to reflect payments received and gain recognized in prior taxable years, shall be applied to payments received in that taxable year.

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(iii)*Examples.*— The following examples illustrate installment method reporting of a contingent payment sale under which there is a stated maximum selling price. In each example, it is assumed that application of the rules described will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A owns all of the stock of X corporation with a basis to A of $20 million. On July 1, 1981, A sells the stock of X to B under an agreement calling for fifteen annual payments respectively equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Each payment is to be made on the following June 15th, commencing June 15, 1982, together with adequate stated interest. The agreement specifies that the maximum amount (exclusive of interest) payable to A shall not exceed $60 million. Since stated interest is payable as an addition to the selling price and the specified rate is not below the section 483 test rate, there is no internal interest under the agreement. The stated maximum selling price is $60 million. The gross profit ratio is 2/3 (gross profit of $40 million divided by $60 million contract price). Thus, if on June 15, 1982, A receives a payment of $3 million (exclusive of interest) under the agreement, in that year A will report $2 million ($3 million × 2/3) as gain attributable to the sale, and $1 million as recovery of basis.

Example (2). (i) The facts are the same as in example (1) except that the agreement does not call for the payment of any stated interest but does provide for an initial cash payment of $3 million on July 1, 1981. The maximum amount payable, including the $3 million initial payment, remains $60 million. Since section 483 will apply to each payment received by A more than one year following the date of sale (section 483 is inapplicable to the contingent payment that will be received on June 15, 1982 since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price-interest recomputation rule is applicable. Under the rule, an initial determination must be made for A's taxable year 1981. On December 31, 1981, the last day of the taxable year, no events with regard to the first fiscal year have occurred which are subject to prompt subsequent calculation and verification because that fiscal year will end March 31, 1982. Under the price-interest recomputation rule, on December 31, 1981 A is required to assume that the maximum amount subsequently payable under the agreement ($57 million, equal to $60 million less the $3 million initial cash payment received by A in 1981) will be paid on the earliest date permissible under the agreement, *i.e.,* on June 15, 1982. Since no part of a payment received on that date would be treated as interest under section 483, the initial stated maximum selling price, applicable to A's 1981 tax calculation, is deemed to be $60 million. Thus, the 1981 gross profit ratio is 2/3 and for the taxable year 1981 A will report $2 million as gain attributable to the sale.

(ii) The net profits of X for its fiscal year ending March 31, 1982 are $100 million. On June 15, 1982 A receives a payment from B equal to 5% of that amount, or $6 million. On December 31, 1982, A knows that the maximum amount he may subsequently receive under the agreement is $51 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1983. Section 483 does not treat as interest any part of the $6 million received by A on June 15, 1982, but section 483 will treat as unstated interest a computed part of the $51 million it is assumed A will receive on June 15, 1983. Assuming that under the tables in the regulations under section 483, it is determined that the principal component of a payment received more than 21 months but less than 27 months after the date of sale is considered to be .82270, $41,957,700 of the presumed $51 million payment will be treated as principal. The balance of $9,042,300 is interest. Accordingly, in A's 1982 tax calculations stated maximum selling price will be $50,957,700, which amount is equal to the stated maximum selling price that was determined in the 1981 tax calculations ($60 million) reduced by the section 483 interest component of the $6 million payment received by A in 1982 ($0) and further reduced by the section 483 interest component of the $51 million presumed payment to be received by A on June 15, 1983 ($9,042,300). Similarly, in determining gross profit for 1982 tax calculations, the gross profit of $40 million determined in the 1981 tax calculations must be reduced by the same section 483 interest amounts, yielding a recomputed gross profit of $30,957,700 ($40,000,000 # $9,042,300). Further, since prior to 1982 A received payment under the agreement (1981 payment

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of $3 million of which $2 million was profit), the appropriate amounts must be subtracted in the 1982 tax calculation. The total previously received selling price payment of $3 million is subtracted from the recomputed maximum selling price of $50,957,700, yielding an adjusted selling price of $47,957,700. The total previously recognized gain of $2 million is subtracted from the recomputed maximum gross profit of $30,957,700, yielding an adjusted gross profit of $28,957,700. The gross profit percentage applicable to 1982 tax calculations thus is determined to be 60.38175%, equal to the quotient of dividing the adjusted gross profit of $28,957,700 by the adjusted selling price of $47,957,700. Accordingly, of the $6 million received by A in 1982, no part of which is unstated interest under section 483, A will report $3,622,905 (60.38175% of $6 million) as gain attributable to the sale and $2,377,095 ($6,000,000 # $3,622,905) as recovery of basis.

(iii) The net profits of X for its fiscal year ending March 31, 1983 are $200 million. On June 15, 1983 A receives a payment from B equal to $10 million. On December 31, 1983, A knows that the maximum amount he may subsequently receive under the agreement is $41 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1984. Assuming that under the tables in the regulations under section 483 it is determined that the principal component of a payment received more than 33 months but less than 39 months after the date of sale is .74622, $30,595,020 of the presumed $41 million ($51 million # $10 million) payment will be treated as principal and $10,404,980 is interest. Based upon the assumed factor for 21 months but less than 27 months (.82270) $8,227,000 of the $10 million payment is principal and $1,733,000 is interest. Accordingly, in A's 1983 tax calculations stated maximum selling price will be $47,822,020, which amount is equal to the stated maximum selling price determined in the 1981 calculation ($60 million) reduced by the section 483 interest component of the $6 million 1982 payment ($0), the section 483 interest component of the 1983 payment ($1,773,000) and by the section 483 interest component of the presumed $41 million payment to be received in 1984 ($10,404,980). The recomputed gross profit is $27,822,020 ($40 million # $10,404,980 # $1,773,000). The previously reported payments must be deducted for the 1983 calculation. Selling price is reduced to $38,822,020 by subtracting the $3 million 1981 payment and the $6 million 1982 payment ($47,822,020 # $9 million) and gross profit is reduced to $22,199,115 by subtracting the 1981 profit of $2 million and the 1982 profit of $3,622,905 ($27,822,020 # $5,622,905), yielding a gross profit percentage of 57.18176% ($22,199,115/$38,822,020). Accordingly, of the $10 million received in 1983, A will report $1,773,000 as interest under section 483, and of the remaining principal component of $8,227,000, $4,704,343 as gain attributable to the sale ($8,227,000 × 57.18176%) and $3,522,657 ($8,227,000 # $4,704,343) as recovery of basis.

Example (3). The facts are the same as in example (2) except that X is a collapsible corporation as defined in section 341(b)(1) and no limitation or exception under section 341(d), (e), or (f) is applicable. Under section 341(a), all of A's gain on the sale will be ordinary income. Accordingly, section 483 will not apply to treat as interest any part of the payments to be received by A under his agreement with B. See section 483(f)(3). Therefore, the price-interest recomputation rule is inapplicable and the tax results to A in each year in which payment is received will be determined in a manner consistent with example (1).

Example (4). The facts are the same as in example (2) (maximum amount payable under the agreement $60 million) except that the agreement between A and B contains the following "payment recharacterization" provision:

"Any payment made more than one year after the (July 1, 1981) date of sale shall be composed of an interest element and a principal element, the interest element being computed on the principal element at an interest rate of 9% per annum computed from the date of sale to the date of payment."

The results reached in example (2), with respect to the $3 million initial cash payment received by A in 1981 remain the same because, under the payment recharacterization formula, no amount received or assumed to be received prior to July 1, 1982 is treated as interest. The 1982 tax computation method described in example (2) is equally applicable to the $6 million payment received in 1982. However, the adjusted gross profit ratio determined in this example (4) will differ from the ratio determined in example (2). The difference is attributable to the difference between a

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9% stated interest rate calculation (in this example (4)) and the compound rate of unstated interest required under section 483 and used in calculating the results in example (2).

Example (5). The facts are the same as in example (1). In 1992 X is adjudged a bankrupt and it is determined that, in and after 1992, B will not be required to make any further payments under the agreement, *i.e.,* B's contingent payment obligation held by A now has become worthless. Assume that A previously received aggregate payments (exclusive of interest) of $45 million and out of those payments recovered $15 million of A's total $20 million basis. For 1992 A will report a loss of $5 million attributable to the sale, taken at the time determined to be appropriate under the rules generally applicable to worthless debts.

Example (6). (i) C owns all of the stock of Z corporation, a calendar year taxpayer. On July 1, 1981, C sells the stock of Z to D under an agreement calling for payment, each year for the next ten years, of an amount equal to 10% of the net profits of Z earned in the immediately preceding calendar year beginning with the year ending December 31, 1981. Each payment is to be made on the following April 1st, commencing April 1, 1982. In addition, C is to receive a payment of $5 million on closing. The agreement specifies that the maximum amount payable to C, including the $5 million cash payment at closing, is $24 million. The agreement does not call for the payment of any stated interest. Since section 483 will apply to each payment received by C more than one year following the date of sale (section 483 is inapplicable to the payment that will be received on April 1, 1982, since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price interest recomputation rule is applicable. Under that rule, C must make an initial determination for his taxable year 1981.

(ii) On December 31, 1981, the exact amount of Z's 1981 net profit is not known, since it normally takes a number of weeks to compile the relevant information. However, the events which will determine the amount of the payment C will receive on April 1, 1982 have already occurred, and the information (Z's 1981 financial statement) will be promptly calculated and verified and will be available prior to the time C's 1981 tax return is timely filed. On March 15, 1982, Z reports net income of $14 million, and on April 1, 1982 D pays C $1.4 million.

(iii) Under the price-interest recomputation rule, C is required to determine the gross profit ratio for the 1981 $5 million payment on the basis of the events which occurred by the close of that taxable year and which are verifiable before the due date of the 1981 return. Because at the end of C's 1981 taxable year all events which will determine the amount of the April 1, 1982 payment have occurred and because the actual facts are known prior to the due date of C's return, C will take those facts into account when calculating the gross profit ratio. Thus, because C knows that the 1982 payment is $1.4 million, C knows that the remaining amount to be recovered under the contract is $17.6 million ($24 million # ($5 million + $1.4 million)). For purposes of this paragraph C must assume that the entire $17.6 million will be paid on the earliest possible date, April 1, 1983. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $15,203,584 of the $17.6 million would be principal and $2,396,416 ($17,600,000 # $15,203,584) would be interest. Therefore C must assume, for purposes of reporting the $5 million payment received in 1981, that the selling price is $21,603,584 calculated as follows:

	$24,000,000	Total selling price
#	2,396,416	Interest component of the $17,600,000 payment which C must assume will be made April 1, 1983.
	$21,603,584	Adjusted selling price to be used when reporting the 1981 payment.

(iv) Assume that on March 15, 1982, Z reports net income of $15 million for 1982 and that on April 1, 1983 D pays C $1.5 million. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $1,295,760 of the $1,500,000 payment will be principal and $204,240 ($1,500,000 # $1,295,760) will be interest. Because C

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knows the amount of the 1983 payment when filing the 1982 tax return, C must assume that the remaining amount to be received under the contract, $16.1 million ($24 million # ($5 million + $1.4 million + $1.5 million)), will be received as a lump sum on April 1, 1984. Because section 483 will again apply, and assuming that the principal component of a payment made 34 months after the date of the sale is .74622, $12,014,142 of the $16.1 million would be principal, and $4,085,858 ($16,100,000 # $12,014,142) would be interest. Therefore, C must assume, for purpose of reporting the $1.4 million payment made April 1, 1982, that the adjusted selling price (within the meaning of example (2)) is $14,709,902, calculated as follows:

	$24,000,000	Total selling price
#	204,240	Interest component of the $1,500,000 payment made April 1, 1983.
#	$ 4,085,858	Interest component of the $16,100,000 payment which C must assume will be made April 1, 1984.
#	5,000,000	Payment made in 1981.
	$14,709,902	Adjusted selling price for calculations for reporting the 1982 payment.

(3)*Fixed period*

(i)*In general.—* When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless. When no loss is allowed, the unrecovered portion of the basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. If application of the foregoing rules to a particular case would substantially and inappropriately defer or accelerate recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(ii)*Examples.—* The following examples illustrate the rules for recovery of basis in a contingent payment sale in which stated maximum selling price cannot be determined but the period over which payments are to be received under the agreement is fixed. In each case, it is assumed that application of the described rules will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A sells Blackacre to B for 10 percent of Blackacre's gross yield for each of the next 5 years. A's basis in Blackacre is $5 million. Since the sales price is indefinite and the maximum selling price is not ascertainable from the terms of the contract, basis is recovered ratably over the period during which payment may be received under the contract. Thus, assuming A receives the payments (exclusive of interest) listed in the following table, A will report the following:

Year	***Payment***	***Basis Recovered***	***Gain Attributable***

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			to the Sale
1	$1,300,000	$1,000,000	$300,000
2	$1,500,000	$1,000,000	$500,000
3	$1,400,000	$1,000,000	$400,000
4	$1,800,000	$1,000,000	$800,000
5	$2,100,000	$1,000,000	$1,100,000

Example (2). The facts are the same as in example (1), except that the payment in year 1 is only $900,000. Since the installment payment is less than the amount of basis allocated to that year, the unrecovered basis, $100,000, is carried forward to year 2.

			Gain
		Basis	**Attributable**
Year	**Payment**	**Recovered**	**to the Sale**
1	$900,000	$900,000	—0—
2	$1,500,000	$1,100,000	$400,000
3	$1,400,000	$1,000,000	$400,000
4	$1,800,000	$1,000,000	$800,000
5	$2,100,000	$1,000,000	$1,100,000

Example (3). C owns all of the stock of X corporation with a basis of $100,000 (inclusive of selling expenses). D purchases the X stock from C and agrees to make four payments computed in accordance with the following formula: 40% of the net profits of X in year 1, 30% in year 2, 20% in year 3, and 10% in year 4. Accordingly, C's basis is allocated as follows: $40,000 to year 1, $30,000 to year 2, $20,000 to year 3, and $10,000 to year 4.

Example (4). The facts are the same as in example (3), but the agreement also requires that D make fixed installment payments in accordance with the following schedule: no payment in year 1, $100,000 in year 2, $200,000 in year 3, $300,000 in year 4, and $400,000 in year 5. Thus, while it is reasonable to project that the contingent component of the payments will decrease each year, the fixed component of the payments will increase each year. Accordingly, C is required to allocate $20,000 of basis to each of the taxable years 1 through 5.

(4)*Neither stated maximum selling price nor fixed period.—* If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized. If, taking into account all of the pertinent facts, including the nature of the property, the arrangement is determined to qualify as a sale, the taxpayer's basis (including selling expenses) shall be recovered in equal annual increments over a period of 15 years commencing with the date of sale. However, if in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than basis allocated to the year, no loss shall be allowed unless it is otherwise determined in accordance with the timing rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless; instead the excess basis shall be reallocated in level amounts over the balance of the 15-year term. Any basis not recovered at the end of the 15th year shall be carried forward to the next succeeding year, and to the extent unrecovered thereafter shall be carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless. The general rule requiring initial level allocation of basis over 15 years shall not apply if the taxpayer can establish to the satisfaction of the Internal Revenue Service that application of the general rule would substantially and inappropriately defer recovery of the taxpayer's basis. See paragraph (c)(7) of this section. If the Service determines that initially allocating basis in level amounts over the first 15 years will substantially and inappropriately accelerate recovery of the taxpayer's basis in early years of that 15-year term, the Service may require that basis be reallocated within the 15-

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year term but the Service will not require that basis initially be allocated over more than 15 years. See paragraph (c)(7) of this section.

(5)*Foreign currency and other fungible payment units*

(i)*In general.—* An installment sale may call for payment in foreign currency. For federal income tax purposes, foreign currency is property. Because the value of foreign currency will vary over time in relation to the United States dollar, an installment sale requiring payment in foreign currency is a contingent payment sale. However, when the consideration payable under an installment sale agreement is specified in foreign currency, the taxpayer's basis (including selling expenses) shall be recovered in the same manner as basis would have been recovered had the agreement called for payment in United States dollars. This rule is equally applicable to any installment sale in which the agreement specifies that payment shall be made in identified, fungible units of property the value of which will or may vary over time in relation to the dollar (*e.g.,* bushels of wheat or ounces of gold).

(ii)*Example.—* The following example illustrates the provisions of this subparagraph:

Example. A sells Blackacre to B for 4 million Swiss francs payable 1 million in year 2 and 3 million in year 3, together with adequate stated interest. A's basis (including selling expenses) in Blackacre is $100,000. Twenty-five thousand dollars of A's basis (¼ of total basis) is allocable to the year 2 payment of 1 million Swiss francs and $75,000 of A's basis is allocable to the year 3 payment of 3 million Swiss francs.

(6)*Income forecast method for basis recovery*

(i)*In general.—* The rules for ratable recovery of basis set forth in paragraph (c)(2) through (4) of this section focus on the payment terms of the contingent selling price agreement. Except to the extent contemplated by paragraph (c)(7) of this section (relating to a special rule to prevent substantial distortion of basis recovery), the nature and productivity of the property sold is not independently relevant to the basis to be recovered in any payment year. The special rule for an income forecast method of basis recovery set forth in paragraph (c)(6) of this section recognizes that there are cases in which failure to take account of the nature or productivity of the property sold may be expected to result in distortion of the taxpayer's income over time. Specifically, when the property sold is depreciable property of a type normally eligible for depreciation on the income forecast method, or is depletable property of a type normally eligible for cost depletion in which total future production must be estimated, and payments under the contingent selling price agreement are based upon receipts or units produced by or from the property, the taxpayer's basis may appropriately be recovered by using an income forecast method.

(ii)*Availability of methods.—* In lieu of applying the rules set forth in paragraph (c)(2) through (4) of this section, in an appropriate case the taxpayer may elect (on its tax return timely filed for the first year under the contingent payment agreement in which a payment is received) to recover basis using the income forecast method of basis recovery. No special form of election is prescribed. An appropriate case is one meeting the criteria set forth in paragraph (c)(6)(i) of this section in which the property sold is a mineral property, a motion picture film, a television film, or a taped television show. The Internal Revenue Service may from time to time specify other properties of a similar character which, in appropriate circumstances, will be eligible for recovery of basis on the income forecast method. In addition, a taxpayer may seek a ruling from the Service as to whether a specific property qualifies as property of a similar character eligible, in appropriate circumstances, for income forecast recovery of basis.

(iii)*Required calculations.—* The income forecast method requires application of a fraction, the numerator of which is the payment (exclusive of interest) received in the taxable year under a contingent payment agreement, and the denominator of which is the forecast or estimated total payments (exclusive of interest) to be received under the agreement. This fraction is

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multiplied by the taxpayer's basis in the property sold to determine the basis recovered with respect to the payment received in the taxable year. If in a subsequent year it is found that the income forecast was substantially overestimated or underestimated by reason of circumstances occurring in such subsequent year, an adjustment of the income forecast for such subsequent year shall be made. In such case, the formula for computing recovery of basis would be as follows: payment received in the taxable year (exclusive of interest) divided by the revised estimated total payments (exclusive of interest) then and thereafter to be made under the agreement (the current year's payment and total estimated future payments), multiplied by the taxpayer's unrecovered basis remaining as of the beginning of the taxable year. If the agreement contemplates internal interest (as defined in paragraph (c)(2)(ii) of this section), in making the initial income forecast computation and in making any required subsequent recomputation the amount of internal interest (which shall not be treated as payment under the agreement) shall be calculated by assuming that each future contingent selling price payment will be made in the amount and at the time forecast. The total forecast of estimated payments to be received under the agreement shall be based on the conditions known to exist at the end of the taxable year for which the return is filed. If a subsequent upward or downward revision of this estimate is required, the revision shall be made at the end of the subsequent taxable year based on additional information which became available after the last prior estimate. No loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to the time a debt becomes worthless that the future payment obligation under the agreement has become worthless.

(iv)*Examples.—* The following examples illustrate the income forecast method of basis recovery:

Example (1). A sells a television film to B for 5% of annual gross receipts from the exploitation of the film. The film is an ordinary income asset in the hands of A. A reasonably forecasts that total payments to be received under the contingent selling price agreement will be $1,200,000, and that A will be paid $600,000 in year 1, $150,000 in year 2, $300,000 in year 3, $100,000 in year 4, and $50,000 in year 5. A reasonably anticipates no or only insignificant receipts thereafter. A's basis in the film is $100,000. Under the income forecast method, A's basis initially is allocated to the five taxable years of forecasted payment as follows:

Year	*Percentage*	*Basis*
1	50.00%	$50,000
2	12.50%	$12,500
3	25.00%	$25,000
4	8.33%	$8,333
5	4.17%	$4,167

Payments are received and A reports the sale under the installment method as follows:

Year	*Payment Received*	*Basis Recovered*	*Gain on Sale*
1	$600,000	$50,000	$550,000
2	$150,000	$12,500	$137,500
3	$300,000	$25,000	$275,000
4	$100,000	$8,333	$91,667
5	$50,000	$4,167	$45,833

Example (2). The facts are the same as in example (1), except that in year 2 A receives no payment. In year 3 A receives a payment of $300,000 and reasonably estimates that in subsequent years he will receive total additional payments of only $100,000. In year 2 A will be allowed no loss. At the beginning of year 3 A's unrecovered basis is $50,000. In year 3 A must recompute the applicable basis recovery fraction based upon facts known and forecast as at the end of year 3: year 3 payment of $300,000 divided by estimated current and future payments of

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$400,000, equaling 75%. Thus, in year 3 A recovers $37,500 (75% of $50,000) of A's previously unrecovered basis.

(7)*Special rule to avoid substantial distortion*

(i)*In general.—* The normal basis recovery rules set forth in paragraph (c)(2) through (4) of this section may, with respect to a particular contingent payment sale, substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

(ii)*Substantial and inappropriate deferral.—* The taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery described in paragraph (c)(7)(ii) of this section.

The request for a ruling shall be made in accordance with all applicable procedural rules set forth in the Statement of Procedural Rules (26 CFR Part 601) and any applicable revenue procedures relating to submission of ruling requests. The request shall be submitted to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224. The taxpayer must file a request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred (*e.g.,* corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

(iii)*Substantial and inappropriate acceleration.—* Notwithstanding the other provisions of this paragraph, the Internal Revenue Service may find that the normal basis recovery rule will substantially and inappropriately accelerate recovery of basis. In such a case, the Service may require an alternate method of basis recovery, unless the taxpayer is able to demonstrate either (A) that the method of basis recovery required by the Service is not a reasonable method of ratable recovery, or (B) that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the Service. In making such demonstrations the taxpayer may rely in appropriate circumstances upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. In special circumstances a reasonable projection may be acceptable, but only with the consent of the Service, if the projection is based upon a specific event that has already occurred.

(iv)*Subsequent recomputation.—* A contingent payment sale may initially and properly have been reported under the normally applicable basis recovery rule and, during the term of the agreement, circumstances may show that continued reporting on the original method will substantially and inappropriately defer or accelerate recovery of the unrecovered balance of the taxpayer's basis. In this event, the special rule provided in this paragraph is applicable.

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(v)*Examples.—* The following examples illustrate the application of the special rule of this paragraph. In examples (1) and (2) it is assumed that rulings consistent with paragraph (c)(7)(ii) of this section have been requested.

Example (1). A owns all of the stock of X corporation with a basis of $100,000. A sells the stock of X to B for a cash down payment of $1,800,000 and B's agreement to pay A an amount equal to 1% of the net profits of X in each of the next 10 years (together with adequate stated interest). The agreement further specifies that the maximum amount that may be paid to A (exclusive of interest) shall not exceed $10 million. A is able to demonstrate that current and recent profits of X have approximated $2 million annually, and that there is no reason to anticipate a major increase in the annual profits of X during the next 10 years. One percent of $2 million annual profits is $20,000, a total of $200,000 over 10 years. Under the basis recovery rule normally applicable to a maximum contingent selling price agreement, in the year of sale A would recover $18,000 of A's total $100,000 basis, and would not recover more than a minor part of the balance until the final year under the agreement. On a $2 million selling price ($200,000 plus $1,800,000 down payment), A would recover $90,000 of A's total $100,000 basis in the year of sale and 5% of each payment ($100,000/$2,000,000) received up to a maximum of $10,000 over the next ten years. Since the rate of basis recovery under the demonstrated method is more than twice the rate under the normal rule, A will be permitted to recover $90,000 basis in the year of sale.

Example (2). The facts are the same as in example (1) except that no maximum contingent selling price is stated in the agreement. Under the basis recovery rule normally applicable when no maximum amount is stated but the payment term is fixed, in the year of sale and in each subsequent year A would recover approximately $9,100 (1/11 of $100,000) of A's total basis. A will be permitted to recover $90,000 of A's total basis in the year of sale.

Example (3). The facts are the same as in example (1) except that A sells the X stock to B on the following terms: 1% of the annual net profits of X in each of the next 10 years and a cash payment of $1,800,000 in the eleventh year, all payments to be made together with adequate stated interest. No maximum contingent selling price is stated. Under the normally applicable basis recovery rule, A would recover 1/11 of A's total $100,000 basis in each of the 11 payment years under the agreement. On the facts (see example (1)), A cannot demonstrate that application of the normal rule would not substantially and inappropriately accelerate recovery of A's basis. Accordingly, A will be allowed to recover only $1,000 of A's total basis in each of the 10 contingent payment years under the agreement, and will recover the $90,000 balance of A's basis in the final year in which the large fixed cash payment will be made.

(8)*Coordination with regulations under section 385.*

(i)*In general.—* The regulations under section 385 do not apply to an instrument (as defined in § 1.385-3(c)) providing for a contingent payment of principal (with or without stated interest) issued in connection with a sale or other disposition of property to a corporation if § 1.385-6 (relating to proportionality) does not apply to such instrument (or to a class of instruments which includes such instrument). Thus, such instrument will be treated as stock or indebtedness under applicable principles of law without reference to the regulations under section 385.

(ii)*Examples.—* The following examples illustrate the application of this paragraph:

Example (1). On January 1, 1982, corporation X buys a factory from Y, an independent creditor (within the meaning of § 1.385-6(b)). In exchange for the factory, Y receives $200,000 in cash on January 1, 1982. In addition, on January 1, 1984, Y will receive a payment in the range of $100,000 to $300,000, plus adequate stated interest, depending on the factory's output. Based on these facts, § 1.385-6 does not apply to X's obligation to Y (see § 1.385-6(a)(3)(ii)) and the regulations under section 385 do not apply to X's obligation to Y.

Example (2). The facts are the same as in example (1), except that the contingent payment due on January 1, 1984 will be in the range of $50,000 to $250,000. In addition, on January 1, 1982, Y receives a $50,000 noninterest-bearing note due absolutely and unconditionally on January

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1, 1984. Based on these facts, the $50,000 note is treated as stock or indebtedness under the regulations under section 385.

(d) *Election not to report an installment sale on the installment method*

(1) ***In general.—*** An installment sale is to be reported on the installment method unless the taxpayer elects otherwise in accordance with the rules set forth in paragraph (d)(3) of this section.

(2) *Treatment of an installment sale when a taxpayer elects not to report on the installment method*

(i) ***In general.—*** A taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting. The fair market value of an installment obligation shall be determined in accordance with paragraph (d)(2)(ii) and (iii) of this section. In making such determination, any provision of contract or local law restricting the transferability of the installment obligation shall be disregarded. Receipt of an installment obligation shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, whether or not such obligation is the equivalent of cash. An installment obligation is considered to be property and is subject to valuation, as provided in paragraph (d)(2)(ii) and (iii) of this section, without regard to whether the obligation is embodied in a note, an executory contract, or any other instrument, or is an oral promise enforceable under local law.

(ii) *Fixed amount obligations*

(A) A fixed amount obligation means an installment obligation the amount payable under which is fixed. Solely for the purpose of determining whether the amount payable under an installment obligation is fixed, the provisions of section 483 and any "payment recharacterization" arrangement (as defined in paragraph (c)(2)(ii) of this section) shall be disregarded. If the fixed amount payable is stated in identified, fungible units of property the value of which will or may vary over time in relation to the United States dollar (*e.g.,* foreign currency, ounces of gold, or bushels of wheat), such units shall be converted to United States dollars at the rate of exchange or dollar value on the date the installment sale is made. A taxpayer using the cash receipts and disbursements methods of accounting shall treat as an amount realized in the year of sale the fair market value of the installment obligation. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the property sold (minus any another consideration received by the taxpayer on the sale). A taxpayer using the accrual method of accounting shall treat as an amount realized in the year of sale the total amount payable under the installment obligation. For this purpose, neither interest (whether stated or unstated) nor original issue discount is considered to be part of the amount payable. If the amount payable is otherwise fixed, but because the time over which payments may be made is contingent, a portion of the fixed amount will or may be treated as internal interest (as defined in paragraph (c)(2)(ii) of this section), the amount payable shall be determined by applying the price interest recomputation rule (described in paragraph (c)(2)(ii) of this section). Under no circumstances will an installment sale for a fixed amount obligation be considered an "open" transaction. For purposes of this (ii) remote or incidental contingencies are not to be taken into account.

(B) The following examples illustrate the provisions of paragraph (d)(2) of this section.

Example (1). A, an accrual method taxpayer, owns all of the stock of X corporation with a basis of $20 million. On July 1, 1981, A sells the stock of X corporation to B for $60 million payable on June 15, 1992. The agreement also provides that, against this fixed amount, B shall make annual prepayments (on June 15) equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Thus, the first prepayment will be made on June 15, 1982. No stated interest is payable under the agreement and thus the unstated interest provisions of section 483 are applicable.

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Under section 483, no part of any payment made on June 15, 1982 (which is within one year following the July 1, 1981 sale date), will be treated as unstated interest. Under the price interest recomputation rule, it is presumed that the entire $60 million fixed amount will be paid on June 15, 1982. Accordingly, if A elects not to report the transaction on the installment method, in 1981 A must report $60 million as the amount realized on the sale and must report $40 million as gain on the sale in that year.

Example (2). The facts are the same as in example (1) except that A uses the cash receipts and disbursements method of accounting. In 1981 A must report as an amount realized on the sale the fair market value of the installment obligation and must report as gain on the sale in 1981 the excess of that amount realized over A's basis of $20 million. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the stock of X. In determining the fair market value of the installment obligation, any contractual or legal restrictions on the transferability of the installment obligation, and any remote or incidental contingencies otherwise affecting the amount payable or time of payments under the installment obligation, shall be disregarded.

(iii)*Contingent payment obligations.—* Any installment obligation which is not a fixed amount obligation (as defined in paragraph (d)(2)(ii) of this section) is a contingent payment obligation. If an installment obligation contains both a fixed amount component and a contingent payment component, the fixed amount component shall be treated under the rules of paragraph (d)(2)(ii) of this section and the contingent amount component shall be treated under the rules of this (iii). The fair market value of a contingent payment obligation shall be determined by disregarding any restrictions on transfer imposed by agreement or under local law. The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale). Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is "open." Any such transaction will be carefully scrutinized to determine whether a sale in fact has taken place. A taxpayer using the cash receipts and disbursements method of accounting must report as an amount realized in the year of sale the fair market value of the contingent payment obligation. A taxpayer using the accrual method of accounting must report an amount realized in the year of sale determined in accordance with that method of accounting, but in no event less than the fair market value of the contingent payment obligation.

(3)*Time and manner for making election*

(i)*In general.—* An election under paragraph (d)(1) of this section must be made on or before the due date prescribed by law (including extensions) for filing the taxpayer's return for the taxable year in which the installment sale occurs. The election must be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election under paragraph (d)(1) of this section. A cash method taxpayer receiving an obligation the fair market value of which is less than the face value must make the election in the manner prescribed by appropriate instructions for the return filed for the taxable year of the sale.

(ii)*Election made after the due date.—* Elections after the time specified in paragraph (d)(3)(i) of this section will be permitted only in those rare circumstances when the Internal Revenue Service concludes that the taxpayer had good cause for failing to make a timely election. A recharacterization of a transaction as a sale in a taxable year subsequent to the taxable year in which the transaction occurred (*e.g.,* a transaction initially reported as a lease later is determined to have been an installment sale) will not justify a late election. No conditional

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elections will be permitted. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(4)*Revoking an election.—* Generally, an election made under paragraph (d)(1) is irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. A revocation is retroactive. A revocation will not be permitted when one of its purposes is the avoidance of federal income taxes, or when the taxable year in which any payment was received has closed. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(5)*Transitional rules.—* The following transitional rules shall apply with respect to any contingent payment sale made after October 19, 1980 in a taxable year, ending after that date, for which the taxpayer has filed a federal income tax return prior to February 19, 1981. If in such tax return the taxpayer has treated the contingent payment sale under the installment method, consent of the Internal Revenue Service to a late election by the taxpayer not to report the transaction on the installment method will generally be granted if the request for election out of installment method treatment is filed by May 5, 1981. If in such tax return the taxpayer has elected not to report the contingent payment sale under the installment method, consent of the Service to revocation of the election by the taxpayer will generally be granted if the request for revocation is filed by May 5, 1981.

(e)*Purchaser evidences of indebtedness payable on demand or readily tradable*

(1)*Treatment as payment*

(i)*In general.—* A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall be treated as a payment in the year received, not as installment obligations payable in future years. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(A) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(B) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(C) In any other form designed to render such obligation readily tradable in an established securities market,

shall be treated as a payment in the year received, not as an installment obligation payable in future years. For purposes of this paragraph, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(ii)*Examples.—* The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On July 1, 1981, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1,000,000) to corporation Y in exchange for 250 of Y's registered bonds (which are traded in an over-the-counter market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 12 percent per year), and Y's unsecured promissory note with a principal amount of $750,000. At the time of such exchange A's basis in the X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1 of each year following 1981 until the principal balance is paid. The note provides for the payment of interest at the rate of 12 percent per year also

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payable on July 1 of each year. Under the rule stated in paragraph (e)(1)(i) of this section, the 250 registered bonds of Y are treated as a payment in 1981 in the amount of the value of the bonds, $250,000.

Example (2). Assume the same facts as in example (1). Assume further that on July 1, 1982, Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (*i.e.,* 10 percent gross profit percentage times $75,000), A's gross income for calendar year 1982. In addition, A includes the interest payment made by Y on July 1 in A's gross income for 1982.

(2)*Amounts treated as payment.*— If under paragraph (e)(1) of this section an obligation is treated as a payment in the year received, the amount realized by reason of such payment shall be determined in accordance with the taxpayer's method of accounting. If the taxpayer uses the cash receipts and disbursements method of accounting, the amount realized on such payment is the fair market value of the obligation. If the taxpayer uses the accrual method of accounting, the amount realized on receipt of an obligation payable on demand is the face amount of the obligation, and the amount realized on receipt of an obligation with coupons attached or a readily tradable obligation is the stated redemption price at maturity less any original issue discount (as defined in section 1232(b)(1)) or, if there is no original issue discount, the amount realized is the stated redemption price at maturity appropriately discounted to reflect total unstated interest (as defined in section 483(b)), if any.

(3)*Payable on demand.*— An obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

(4)*Designed to be readily tradable in an established securities market*

(i)*In general.*— Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(A) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(B) If they are treated as readily tradable in an established securities market under paragraph (e)(4)(ii) of this section, or

(C) If they are convertible obligations to which paragraph (e)(5) of this section applies.

(ii)*Readily tradable in an established securities market.*— An obligation will be treated as readily tradable in an established securities market if—

(A) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(B) The corporation issuing the obligation has other obligations of a comparable character which are described in paragraph (e)(4)(ii)(A) of this section.

For purposes of paragraph (e)(4)(ii)(B) of this section, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(iii)*Readily tradable.*— For purposes of paragraph (e)(4)(ii)(A) of this section, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making

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a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(iv)*Established securities market.—* For purposes of this paragraph, the term "established securities market" includes (A) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (B) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1934 (15 U.S.C. 78e) because of its limited volume of transactions, and (C) any over-the-counter market. For purposes of this (iv), an over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer.

(v)*Examples.—* The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1982, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by Y, each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments, each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of Y (determined with reference to the characteristics set forth in paragraph (e)(2) of this section) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradable in an established securities market. The receipt of such bonds by the holder is not treated as a payment for purposes of section 453(f)(4), notwithstanding that they are freely assignable.

Example (2). On April 1, 1981, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for M's negotiable notes, not in registered form and without coupons attached. The M notes are comparable to earlier notes issued by M, which notes are quoted in the Eastern Bond section of the National Daily Quotation Sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principle amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(5)*Special rule for convertible securities*

(i)*General rule.—* If an obligation contains a right whereby the holder of such obligation may convert it directly or indirectly into another obligation which would be treated as a payment under paragraph (e)(1) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (e)(4) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradeable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation into which an obligation is convertible is readily tradeable or designed to be readily tradable in an established securities market, the rules stated in paragraph (e)(4) of this section shall apply, and for purposes of such paragraph (e)(4) if

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such obligation is convertible into stock then the term "stock" shall be substituted for the term "obligation" wherever it appears in such paragraph (e)(4).

(ii)*Substantial discount rule.*— Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of one year from the date the obligation is issued, a substantial discount shall be considered to exist.

(6)*Effective date.*— The provisions of this paragraph (e) shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any questions of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969. [Temporary Reg. §15A.453-1.]

.01 **Historical Comment:** Adopted 1/30/81 by T.D. 7768. Amended 9/30/81 by T.D. 7788 and 4/19/94 by T.D. 8535. [Temporary Reg. § 15A.453-1 does not reflect P.L. 100-203 (1987) or P.L. 108-357 (2004). See 21,402.0365 et seq. and ¶21,406.01 et seq.]

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