Originally published in the:
New York Law Journal ***October 27, 2021***

IRS Cracks Down on Monetized Installment Sales

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If property is sold in a transaction in which the seller is to receive one or more payments at a future date, the transaction will generally be treated as an installment sale for federal income tax purposes. This can allow the seller to recognize gain from the sale as payments are received rather than entirely upfront in the year of the sale.

In recent years, various promotors have marketed so-called “monetized installment sales,” which would purportedly allow a seller to benefit from installment sale treatment while still effectively receiving substantially all of the cash proceeds in the year of the sale. Unsurprisingly, the IRS recently issued a Chief Counsel Advice Memorandum (CCA 202118016) explaining why such transactions should not be respected for income tax purposes.

In a typical monetized installment sale, the taxpayer will have negotiated the sale of property, such as real estate, to a buyer. The taxpayer then sells the property to the promotor in exchange for an interest-only promissory note that matures in 30 years. Immediately thereafter, the promotor sells the property to the buyer for cash equal to the negotiated sales price.

After the property has been sold, an affiliate of the promotor will make a nonrecourse, unsecured loan to the seller for substantially all of the sale proceeds (less the promotor’s fees). This loan will have an identical maturity date to that of the installment loan, and will be designed such that payments under the two loans offset.

Typically, the promotor will deposit interest payments on the installment note into an escrow account, which will then be used to make the taxpayer’s interest payments to the lender. The net result of the transaction is that the taxpayer will receive cash equal to the sales price negotiated with the buyer less the promotor’s fees, and, because of the two offsetting loans, the taxpayer will have no further payment obligations. According to the promotors of monetized installment sales, such a transaction would permit a taxpayer to defer his taxable income from the sale until the maturity of the 30-year installment obligation.

In CCA 202118016, the IRS raised a number of concerns with these types of transactions. First, the “loans” made by the lender to the taxpayer are generally made on an unsecured, nonrecourse basis. These loans are typically unsecured because if a taxpayer incurs indebtedness secured by an installment obligation, the Internal Revenue Code generally treats the taxpayer as if he had actually received payment on the installment obligation.

However, the new IRS guidance rightly points out that a taxpayer would have no reason to repay an unsecured, nonrecourse loan. The IRS will therefore treat the loan as not constituting genuine indebtedness for income tax purposes. Instead, the loan proceeds will be treated as a payment from the lender to the taxpayer that must be included in the taxpayer's taxable income in the year of receipt.

In other monetized installment sale arrangements, the loan from the promotor's affiliate is secured by the taxpayer's installment obligation from the promotor. The IRS memorandum provides that these arrangements should also result in taxable income to the taxpayer. Having the loan secured by the installment obligation directly violates the Code's pledging rules described above, resulting in gain to the taxpayer.

Finally, the IRS memorandum indicates that the third-party buyer, and not the promotor, is in substance the true acquirer of the taxpayer's property. Under the Code, if the taxpayer receives a debt instrument from someone who is not the acquirer of the taxpayer's property, that debt instrument does not qualify for installment sale treatment. Therefore, the promotor's obligation to the taxpayer will be treated as a payment to the taxpayer that is subject to income tax rather than as an installment obligation.

In sum, although many tax practitioners have long thought that monetized installment sales do not achieve the desired tax consequences, this new IRS guidance confirms that such transactions clearly do not work to defer a taxpayer's income from the sale of property. However, there are often other ways to achieve a tax-efficient disposition of real estate that do not run afoul of the tax law, and a taxpayer seeking to defer gain should consider one of those other alternatives.

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