

Reg. Section 15a.453-1(c)(2)

Installment method reporting for sales of real property and casual sales of personal property

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(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) 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 (e)(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.

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.

(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 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 To 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.

Year	Payment	Basis Recovered	Gain Attributable To Sale
1	\$900,000	\$900,000	
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-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 ($\frac{1}{4}$ 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 method. 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 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 of 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 \$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.

(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 the 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.

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.

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

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

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