

Deferred Payment Sales Proposal Unwarranted

To the Editor:

I have just read Prof. Calvin Johnson's Shelf Project article, "Deferred Payment Sales: Change the Basis and Character Rules," *Tax Notes*, July 14, 2008, p. 157, *Doc 2008-14804*, 2008 TNT 136-34. I understand Shelf Project proposals are designed to raise revenue. I clearly don't have the academic chops or tax theory horsepower Prof. Johnson does. As an admitted lightweight, my view of the theory and equity of this proposal is decidedly negative.

As I understand it, Prof. Johnson has proposed (as to both the open transaction rule and installment sales), that the entire amount received in the year of sale would be taxable. Basis would not be recovered pro rata (the current installment sale rule), but would be recovered only after all gain from the sale had been recognized.

Moreover, if the taxpayer otherwise qualified for capital gain treatment on the sale, that treatment would apply only in the year of sale. All installments thereafter would incur ordinary income tax. Thus, one (big) price tag for installment sale treatment would be to have all non-sale year payments treated as ordinary income.

Regarding open transactions, Prof. Johnson suggests that, transactions would be considered closed on the basis of estimates of value. I'm fuzzy on what else he suggests about open transactions, though he does acknowledge that some transactions could not feasibly be closed in the year of sale. In any case, I want to leave Prof. Johnson's open transaction proposals alone, and focus solely on his installment sale proposals.

I don't think I knew that capital gain rates were originally conceived to prevent bunching of income that accrued over many years. Although Prof. Johnson cites some authority for that proposition, I don't know if that was the only historical reason for capital gain rates, nor if today, that is the only reason we still have them. Prof. Johnson also says that capital gain rates unlock capital, but then criticizes installment notes for undercutting more "meritorious" investments. All in all, I'm just not convinced there is anything to commend making installment sale treatment and capital gains mutually exclusive.

True, the open transaction doctrine has long been something the government tries to construe narrowly. There probably have been some taxpayer abuses there (hence my election to stay away from Prof. Johnson's

open transaction proposals). In contrast, though, installment sale treatment just makes sense.

I take it almost as an item of faith that with an installment sale contract, basis is recovered pro rata from each payment. I recognize that I may not follow all of Prof. Johnson's arguments about the economics of lost costs, internal rates of return, and boot in a reorganization. Indeed, on the latter point, I admit I had never thought about the arguable inconsistency between taxing boot up-front in a 1031 exchange or a corporate reorganization, while not taxing installment sale gain up-front (instead recovering basis and taxing gain ratably over the term of the installment note). Prof. Johnson makes a good point about this inconsistency.

Yet, it's not enough to convince me that something as tried and true (and maybe even sacrosanct) as installment sales should be thrown out the window. Aren't annuities taxed in a ratably way much like installment sales? A good student of our tax system (which sadly I am not) could probably think of other examples.

The "basis first" arguments Prof. Johnson advances may be over my head, but I don't get them. I see a few references (in the footnotes) to tax shelters, and I hope the bullseye on installment sales is not somehow intended for tax shelters. If it is, maybe there's another way to let little guys keep installment sales. Regardless of theory, little guys understand the pro rata recovery of basis; to them (and to me) it seems fair.

Prof. Johnson suggests that taxpayers who don't like his new installment sale system could always elect out of installment reporting. They might want to do this to seek capital gain rates on their full gain, even though they would be accelerating all of that gain into the year of sale. Yet, Prof. Johnson also notes that his proposal is not intended to foreclose complete repeal of installment sales. If we are going to gut installment sales as Prof. Johnson proposes, then perhaps we may as well admit we would be performing terminal surgery.

In fact, the first sentence after Prof. Johnson's "complete repeal" sentence is his statement that "[d]eferred recognition under the installment method is not acceptable under nontax accounting standards." See p. 160. Although Prof. Johnson makes other points, maybe this one is his most ardent, that tax and accounting (at least on this item) should be the same. I'm not a student of tax versus accounting differences, but I think it is flatly wrong to require these two regimes to be the same.

It may be true that one could tinker with the installment sale rules. Still, I don't see the theory or rationale for this change, nor (but maybe I'm really missing something here) do I see any abuse. Indeed, as Prof. Johnson notes, the installment method is generally unavailable for sales of inventory, for property held for sale to customers, and for stock or other securities regularly traded on an established market. It seems to me that those carve-outs excise several significant categories of transactions (that perhaps could be abused) from eligibility for installment reporting.

Prof. Johnson notes a few oddities, such as the rule that sales of timeshares and residential lots can be sold on the installment method, even if sold to customers in the ordinary course of a trade or business. I'm guessing this accounts for a puny dollar volume, and even then, there's

an interest charge. Indeed, much more significantly, the fact that an interest charge is levied across the spectrum of installment sales on deferred tax whenever a taxpayer's installment notes exceed \$5 million confines installment sale transactions to relatively modest size. It's the little guys who are doing installment sales. I think we should leave them unmolested.

I'm sure it's always hard to determine whose ox to gore, and the Shelf Project (admirable though it may be) is, I gather, designed to pick the oxen and to target revenue. I just think there must be better places to raise revenue. (Hey, maybe punitive damages should be made nondeductible?) Prof. Johnson states that under current

law, installment sales are estimated to entail loss of revenue of \$7.6 billion over the five-year period 2009-2013. I admit that sounds like a lot of money.

Still, admitting that I may be pigheaded about this, this particular proposal (on installment sales, even if open transactions can't be tolerated) doesn't make sense to me. It strikes me as more than major surgery on a patient that seems perfectly healthy, and has long been a useful member of our society.

Very truly yours,

Robert W. Wood
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