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TAXATION OF PROMISES TO PAY

PATRICIA A. CAIN**

Deferred payment sales of property may create varying types of tax liability for individual sellers. In this Article, Ms. Cain reviews the different methods available for reporting gain on such a transaction with particular emphasis on the valuation of promises to pay received by the seller. Both the timing for reporting gain and the amount of gain a seller is required to report are important elements and both are dependent on the concept of "fair market value." Ms. Cain analyzes the tax consequences of deferred payment sales in relation to both cash and accrual basis taxpayers and suggests that the differential treatment which has evolved is a product of judicial misinterpretation of the tax law.

The taxation of promises to pay is a particularly difficult area in the federal income tax scheme. Most of the difficulties arise in the area of deferred payment sales of property.¹ That is, instead of receiving cash in a sales transaction, the seller may receive a promise from the purchaser that the cash will be paid at some future date.

This promise may be made in many forms. It may be unconditional or it may be dependent upon the happening of some future event. It may consist of a promise to make installment payments over a period of time or to make a lump sum payment on a certain date. The form of the promise will affect the manner in which the sales transaction is taxed. It may determine whether the transaction is immediately taxable or it may determine the amount of the tax.

Another factor besides the form of the promise which must be considered is the method of tax accounting employed by the seller. In many cases accrual basis taxpayers are treated differently from cash basis taxpayers.

The purpose of this Article is threefold. First, there are factors which relate to the form of the promise and to the factual situation

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¹ Problems may arise in other areas as well; e.g., receipt of a promise to pay for services rendered.

surrounding the sales transaction. These factors and their effect on
taxation of the transaction\(^2\) will be fully discussed. Second, the dif-
fferences in treatment between cash and accrual basis taxpayers will
be analyzed. Finally, it will be suggested that these differences are,
in some cases, inappropriate.

I. Methods for Reporting Gain on Deferred Payment Sales

Generally, recognition of gain on the sale of property falls within
the purview of section 1001 of the Internal Revenue Code.\(^3\) Section
1001(a) defines gain as the excess of the "amount realized" on the
sale over the adjusted basis of the property. Section 1001(b) defines
"amount realized" as the sum of any money received plus the fair
market value of any "property (other than money)" received. Prom-
ises to pay fall within the category of "property (other than
money)."\(^4\) Thus the receipt of a promise to pay produces taxable
gain to the extent that the fair market value of the promise received
exceeds the adjusted basis of the property sold.\(^5\)

When a taxpayer sells property and receives a deferred payment
obligation from the purchaser, there are three recognized methods
which may be employed to report any gain. Which is the correct
method depends on the facts of each transaction. The mechanics of
these methods is discussed below.

A. The Closed Transaction Method

Under the "closed" approach, the seller recognizes his entire
gain in the year of sale. According to section 1001 the gain is com-
puted by subtracting the adjusted basis of the property from the
total amount realized on the sale in that year. Receipt of obligations
to pay must be included as an amount realized. Although section
1001 itself does not differentiate between cash and accrual basis
taxpayers, the courts have made such a distinction.\(^6\)

A cash basis taxpayer is only required to include the promise to
pay as an amount realized to the extent of its fair market value.\(^7\) If
the promise to pay is valued at less than face, the taxpayer will have

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\(^2\) These factors may determine whether the gain is immediately taxed and they may affect
determination of the amount of the gain to be taxed.

\(^3\) INT. REV. CODE OF 1954, § 1001.


\(^5\) Accrual basis taxpayers, however, normally value the promise at face. See note 10 infra.

\(^6\) E.g., First Savings & Loan Ass'n, 40 T.C. 474 (1963). See text accompanying notes 132-
34 infra.

to report the difference as discount income as he collects payments on the obligations. For example, taxpayer A (employing the cash method) sells property in which he has an adjusted basis of $50 to B. B pays for the property by giving A a promissory note in the face amount of $300, to be paid in yearly installments of $100 each. If the note is determined to have a present fair market value of only $240,8 then A will report a gain in the year of sale in the amount of $190 (fair market value of the notes less adjusted basis). His basis in the note is then $240. As each $100 payment is received, A will treat 240/300ths as return of basis and 60/300ths as discount income which is taxed at the ordinary rate.

Under the general principles of accrual accounting on the other hand, a closed transaction for the accrual basis taxpayer arises when his right to receive a specific amount becomes fixed.9 Although section 1001 speaks in terms of fair market value, the accrual basis taxpayer will normally accrue the face amount of the buyer's obligations.10

B. Open Transaction Method

The "open" method allows postponement of recognition of gain until the taxpayer has recovered all of his basis in the property sold.11 It is available when the obligations received are incapable of being valued in the year of sale, and consequently, where the trans-

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8 Whether or not a promise to pay is assigned a fair market value of less than face depends on the presence or absence of the factors discussed in Section II.
9 Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934).
10 See text accompanying notes 110-20 infra.
12 Open treatment is allowed if "the obligations received by the vendor have no fair market value. . . ." Treas. Reg. § 1.453-6(a)(2) (1958). The term "no fair market value" means no ascertainable fair market value in contrast to zero fair market value. In theory, there are three possibilities as to fair market value: (1) the fair market value is unascertainable, giving rise to "open" tax treatment; (2) the fair market value is ascertainable and is greater than zero, giving rise to "closed" treatment, and (3) the fair market value is ascertainable, and is equal to zero, giving rise to "closed" treatment. It is possible that use of the phrase "no fair market value" has given rise to confusion. An obligation with "no fair market value" might be interpreted by one court to mean no ascertainable value and by another court to mean zero fair market value. See Note, Taxation of Vendors of Real Property: The Concept of Fair Market Value, 15 STAN. L. REV. 85, 88 (1962). Notes which lack market value because they are worthless are notes which have zero fair market value. An example of a transaction involving a promise to pay that has zero fair market value is the following: Purchaser gives seller an unsecured promissory note in the amount of one million dollars immediately before the purchaser is discharged in bankruptcy. The promisor's available assets are sufficient to pay off only part of his secured indebtedness and none of his unsecured indebtedness. In this extreme example, the unsecured promise to pay would have a zero fair market value, and
action cannot be "closed" for tax purposes. The underlying reason for allowing a taxpayer such treatment is that there are factors surrounding the transaction which make any present computation of gain merely speculative. Since it is uncertain whether the taxpayer will realize any gain at all—or if any, how much gain he will realize—he is allowed to leave the computation of gain "open" for tax purposes. Once he has recovered his basis, any further payments he receives will be reported in full as gain.

It is immediately apparent that availability of the "open" method will affect the time at which gain must be reported. Since payments are first applied toward basis, a taxpayer reporting on this method may defer recognition of gain to some future taxable year. However, there is a further reason why this method is beneficial to the taxpayer. The character of the gain which is eventually reported is determined by the nature of the original transaction. Thus if the sale were of a capital asset, all future payments that are reported as gain will be taxed at the capital gains rate.\(^3\)

Obligations are normally incapable of valuation when payment of the obligation is subject to a significant contingency. The contingency may take the form of—(1) a contingency which affects the ultimate amount that the buyer is obligated to pay;\(^4\) (2) a contingency which affects the probability that the obligation will in fact be paid;\(^5\) or (3) a contingency which affects the time that the buyer's obligation will become due.\(^6\) There are two distinct types of sales transactions in which these contingencies may be present:

1. Sale of property for an indeterminate sales price.—This type of transaction will always involve a contingency of the first type. It may, of course, involve either of the latter two contingencies as well. The obligations received by the seller will have no face amount; rather the amount payable will be expressed in such terms as a percentage of profits. Although the percentage may be fixed, it will always be a percentage of an unknown amount.\(^7\) Obviously since

\(^3\) See Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948).
\(^4\) For example, a promise to pay 5 per cent of Company A's net profit for the coming year.
\(^5\) For example, a promise to pay only if Company A makes a profit for the year.
\(^6\) For example, an unconditional promise to pay when A dies. Since A's death is a certainty, there is no factor affecting the probability of payment in this example. The time of payment is the only uncertainty.
\(^7\) See Burnet v. Logan, 283 U.S. 404 (1931).
the sales price is not ascertainable, neither is the amount of gain realized on the transaction. Such a transaction is properly classified as "open" and should normally be given "open" treatment for tax purposes\(^{18}\) regardless of the method of accounting employed by the taxpayer.

2. Sale of property for a fixed sales price.—This type of transaction should always be classified as "closed." However, it is possible for a "closed" transaction to qualify for "open" tax treatment if it involves a sufficiently contingent promise to pay.\(^{19}\) This variety of transaction will necessarily involve only the latter two contingencies—probability of payment and time of payment—since the ultimate amount of the obligation is fixed by the sales price. Since such a transaction is properly classified as "closed" and yet given "open" tax treatment because of the attendant contingencies, it might be more accurate to describe such a transaction as "ajar."\(^{20}\)

C. The Installment Method

This method is elective and is equally available for cash and accrual basis taxpayers provided they meet the requisites of section 453.\(^{21}\) Since the availability of this method is expressly governed by statute, it does not present the type of difficulties surrounding the "open" and "closed" methods. Basically, this method allows a seller

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\(^{18}\) In some cases, however, a transaction properly classified as "open" may be given "closed" treatment for tax purposes, if it is possible to predict with any degree of certainty the probable amount that will eventually be paid to the seller. See notes 85-88 and accompanying text infra. Indeed, Regulation 1.453-6(a)(2) states that "[o]nly in rare and extraordinary cases does property have no fair market value"—the prerequisite to "open" treatment. This language indicates the strong tendency of the Service to favor "closed" treatment and disfavor "open" treatment.

\(^{19}\) See notes 91-99 and accompanying text infra.

\(^{20}\) Theoretically it would be possible for such a transaction, although originally classified as "open," to be subsequently classified as "closed." For example, at the beginning of year one it may be impossible to assign a fair market value to a promise contingent upon Company A’s making a profit if at that time the company's projected earnings picture is highly speculative. However, if six months into the year the company is doing so well that a projected year-end profit is practically certain, the promise may acquire a fair market value at that time even though the contingency still exists and even though payment is not yet due. There do not appear to be any cases on this point, but logically such a situation could exist. Once the speculation caused by the contingency is removed, there would be nothing to prevent the ascertainment of the promise's fair market value.

\(^{21}\) Int. Rev. Code of 1954, § 453. To use this method, the seller must not receive payments in the year of sale which exceed 30 per cent of the sales price. Also, the sale must be at a price exceeding $1,000. A complete discussion of the installment method is beyond the scope of this Article. For further information on installment reporting, see Ginsberg, Capital Asset Transactions—Casual Sale for Future Payments, 5th So. Fed. Tax Inst. S-1 (1970).
to report income as he receives payments on the obligations. The gain on the sale is determined in the year the sales transaction is completed. The ratio of this gain to the total contract price is the percentage of each installment payment which must be reported as income. Thus if a seller realizes a gain of $10x on a total contract price of $100x, he must recognize as income ten per cent of each payment in the year in which it is actually paid. The other ninety per cent of each payment represents a return of basis. When payments have been received in full, the seller will have recognized his entire gain of $10x.

As noted, the differences in treatment between cash and accrual basis taxpayers usually involve application of either the "open" method or the "closed" method. A partial basis for this differential treatment has evolved from judicial interpretations of section 1001 and its predecessors. The presence or the ascertainability of a "fair market value" has been determinative of whether "open" treatment was available in a particular transaction. The "fair market value" standard for determining whether there is immediate gain and the extent of that gain is a concept that has developed primarily in transactions involving cash basis taxpayers. Therefore, it is in the context of cash basis accounting that the development of the standard will be analyzed.

II. CASH BASIS TAXPAYERS

As a general rule, a cash basis taxpayer must recognize gain when he receives, or constructively receives, cash or its equivalent. Both the doctrine of constructive receipt and the doctrine of cash equivalency were early recognized as exceptions to the original rule that a cash basis taxpayer must report gain only when he receives cash.

22 Treas. Reg. § 1.453-1(b) (1958) speaks in terms of gross profit rather than gain and provides that gross profit shall be the selling price less adjusted basis. Apparently both cash and accrual basis taxpayers would compute their gross profit on the basis of face amount with no consideration of fair market value. The obligations may, however, be subject to the imputed interest regulations. Treas. Reg. § 1.483-1 (1966).

23 See note 6, supra.


26 The doctrine of constructive receipt does not apply to the receipt of promises to make deferred payments in lieu of immediate cash. Thus it is beyond the scope of this Article. Rather, constructive receipt is applicable in situations in which the seller has an immediate, rather than a a future, right to cash and he merely turns his back on that right attempting to defer receipt. For a further analysis of the doctrine, see Sehlossberg, "Cash Equivalent"
In the area of deferred payment sales the doctrine of cash equivalency has come to be replaced by the "fair market value" standard which is now codified in section 1001.

A. Birth of the Fair Market Value Standard

The original provision for determining gain on sales of property required that property received "be treated as the equivalent of cash to the amount of its fair market value, if any. . . ." This language seems to presume that all sales of property will result in immediate taxation. Since the statute dictates that cash equivalency treatment be given to all property received by the seller, seemingly with no necessity for any initial determination of whether the property is in fact the equivalent of cash or whether it does in fact possess a fair market value, its literal application would result in "closed" treatment for all sales by cash basis taxpayers, regardless of the nature of the property received. Partly due to the confusion this language created, the section was altered in 1921 to provide that "no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value. . . ." This language clearly negates the presumption of immediate recognition of gain. The emphasis on "readily realizable market value" implies that the property must be capable of being immediately converted into cash. This section was changed as early as 1924 to read in the same language as the present section 1001—"[t]he amount realized . . . shall be the sum of any money received plus the fair market value of the property (other than money) re-

and "Constructive Receipt"—How These Doctrines Bring Immediate Taxation, 22 J. Tax. 18 (1965).

Revenue Act of February 24, 1919, ch. 18, § 202(b), 40 Stat. 1060.

But see Reg. 45 (1920 ed.) Art. 1563:

Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of, and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.

This language appears to require an initial finding of cash equivalency. It also appears to equate fair market value with cash equivalency, thus contributing to the confusion in this area.


Revenue Act of November 23, 1921, ch. 136, § 202(c), 42 Stat. 230.

eceived.”\textsuperscript{32} Despite this change in statutory language, courts deciding cases under the 1924 Act emphasized the convertibility notion, citing cases decided under the 1921 Act.\textsuperscript{33} Thus the body of case law which has developed in this area has tended to create judicial standards independent of the standard suggested by statute.

Although the change to “fair market value” from the more restrictive standard of “readily realizable market value” may be indicative of congressional intent to equalize tax treatment of cash and accrual basis taxpayers in deferred payment sales of property,\textsuperscript{34} some courts have expressed opposition to the notion of such an equalization.\textsuperscript{35} The reasoning seems to be that since there are provisions which authorize the use of either accounting method,\textsuperscript{36} the two methods are presumed necessarily to produce distinctively different tax consequences. However, to place such emphasis on accounting methods is to read something into the Code that is simply not present. Nowhere in section 446 nor in the regulations promulgated thereunder is there any express provision that a particular transaction may not result in equivalent tax treatment for both types of taxpayers. Furthermore, recognition of gain on sales transactions is explicitly governed by sections 1001 and 1002. There is no provision that methods of accounting should have any effect on the literal application of these sections. Courts which have concerned themselves with making such distinctions have created unnecessary confusion by elevating obsolete notions of cash and accrual basis reporting to a position.

\begin{itemize}
\item \textsuperscript{32} Int. Rev. Code of 1954, § 1001(b).
\item \textsuperscript{33} E.g., Dudley T. Humphrey, 32 B.T.A. 280 (1935). This case cites Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929) and John B. Atkins, 9 B.T.A. 140 (1927) as authority for a present determination of no fair market value. Yet both Bedell and Atkins were applying statutes prior to 1924. Humphrey, on the other hand, involved a 1929 transaction.
\item One writer, in discussing the same factors presented in this Article, suggests that the result of this misinterpretation is that the test for cash basis taxpayers has become whether the deferred payment contract is the equivalent of cash rather than whether there is a fair market value as section 1001 would seem to indicate. Comment, Realization of Income in Deferred Payments Sales, 34 Mo. L. Rev. 357 (1969). Although it is true that the “cash equivalency” standard has been overemphasized by some courts, there is a significant trend toward the more appropriate approach of the “fair market value” standard.
\item \textsuperscript{34} See Levin & Javaras, Receipt of Notes and Other Rights to Future Payments by a Cash Basis Taxpayer, 54 A.B.A.J. 405 (1968).
\item \textsuperscript{35} E.g., Harold W. Johnston, 14 T.C. 560 (1950). In Johnston the court indicated that placing a value on the seller’s right to future contract payments and thereby requiring immediate recognition of gain by him would be entirely inconsistent with the principles of cash basis accounting. To do so would be to tax the seller as though he were an accrual basis taxpayer.
\item \textsuperscript{36} Int. Rev. Code of 1954, § 446.
\end{itemize}
of importance which ignores the significance of the present language of section 1001.

There is a further possible rationale for the court's continuing focus on a taxpayer's ability to convert obligations into ready cash. The underlying theory is that a cash basis taxpayer should not be required to pay a tax if he is unable to convert the property received into actual cash. Otherwise he might find himself obligated to the government when he has no cash in hand with which to satisfy the obligation.

The "fair market value" standard is based on a different rationale. It seems to be derived from the theory that most promises to pay have some value. However, for tax purposes there must be some standard for determining that value which will produce the degree of objectivity and consistency necessary for a fair application of the tax laws. "Fair market value" is such a standard. Whereas the "cash equivalency" rationale tends to overemphasize liquidity-type factors, the "fair market value" rationale is less concerned with the taxpayer's actual ability to convert a promise into immediate cash.

Fair market value is a concept used consistently throughout the Internal Revenue Code, and yet the Code itself offers no precise definition of the term. Although this concept has a much wider application, for purposes of this Article only factors relevant to the fair market value of promises to pay received for property sold will be considered.

For the cash basis taxpayer, immediate taxable gain results only if the promise to pay has a fair market value. Although it does not say so explicitly, section 1001 implies such a result, stating that determination of gain is based on "the fair market value of the property (other than money) received." If the property has no fair market value, the inference is that section 1001 cannot be applied.

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27 A promise to pay may of course have a fair market value equal to zero. This is not to be confused with a promise having no ascertainable fair market value. See note 12 supra.


29 See Note, supra note 12, at 86.

30 For a broader analysis of the concept of fair market value see Gordon, What is Fair Market Value?, 8 Tax. L. Rev. 35 (1952).


33 The phrase "no fair market value" should be interpreted to include no ascertainable fair market value since both nonexistence of fair market value and non-ascertainability of that value can result in "open" treatment. See note 12, supra. For example, an obligation has no
The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value.\textsuperscript{45}

The existence and ascertainability of a "fair market value" for deferred payment obligations will necessitate reporting gain according to the "closed" method. On the other hand, if there is no "fair market value" or if it cannot be accurately ascertained, the taxpayer will be entitled to report his gain according to the "open" method.

The responsibility for making the initial determination as to the existence of fair market value of promises to pay, has been delegated to the courts. The determination is to be made on an ad hoc basis, giving full consideration to the facts of each case.\textsuperscript{46} Guidelines for making this determination are the product of general case law in the area. The rules that have evolved are confusing and at times inconsistent. Courts have tended to emphasize different types of factors in applying the "fair market value" standard of section 1001. The following Section will analyze these factors and suggest guidelines for a more consistent approach.

B. Factors Relevant to the Determination of Fair Market Value

Although the "fair market value" standard has been a part of the Revenue Code since 1924, early cases tended to apply the cash equivalence test, which had been a part of the earlier Acts.\textsuperscript{47} The factors discussed below should demonstrate the trend towards replacing "cash equivalency" with "fair market value."

1. Negotiability of the Instrument.—This is one of the liquidity-type factors so important in the earlier "cash equivalency" determination. Correspondingly, earlier cases attached great weight to the

\textsuperscript{44} Regulation 1.1001-1(a) provides as follows:

The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value.\textsuperscript{45}

\textsuperscript{45} Only in rare and extraordinary cases does property have no fair market value.\textsuperscript{45}

\textsuperscript{46} "Cash equivalency" test

\textsuperscript{47} Cash equivalency test

\textsuperscript{27} See notes 27, 30 supra.
negotiable character of instruments in determining whether they were to be included as an amount realized and, therefore, give rise to recognition of gain. A nonnegotiable promissory note was considered to be a mere evidence of indebtedness and not a payment which represented present gain to a cash basis taxpayer. Consequently gain was not to be reported until actual payment of the note. The same reasoning held true for contractual rights which, absent negotiability, were not treated as the equivalent of cash. The importance attached to negotiability is indicated by the following statement by Judge Learned Hand in Bedell v. Commissioner, a case which considered whether a nonnegotiable promise to pay constituted an amount realized:

If a company sells out a plant for a negotiable bond issue payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. . . . [I]t is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and haggling [sic] with him on a basis of the particular transaction. Even if we could treat the case as an exchange of property, the profit would be realized only when the promise was performed.

The above language implies that this court recognized "fair market value" as the appropriate standard. As Judge Hand indicated in his opinion, the promise could have been sold had the holder found a purchaser. That is, there were no restrictions on assignability. Absent the factor of negotiability, however, the court refused to find that a fair market value existed for the promise to pay. Hence there was no present recognition of gain.

Such decisions appear to ignore the Treasury's position stated as

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18 See, e.g., Commissioner v. Garber, 50 F.2d 588, 591 (9th Cir. 1931).
20 See, e.g., Harold W. Johnston, 14 T.C. 560 (1950). In Nina J. Ennis, 17 T.C. 465 (1951), the Tax Court found that "[i]t is true that the contract possessed many elements of a mortgage . . . but this characteristic does not lend to the contract the necessary element of negotiability." Id. at 470.
21 30 F.2d 622 (2d Cir. 1929).
22 Id. at 624.
early as 1928 in GCM 3350, where a distinction was made between negotiability and marketability in land installment contracts unsupported by notes. The GCM stated, "[t]hese [land installment] contracts are transferrable by assignment; are freely pledged, sold, or otherwise dealt in; are not in any respect conditional; and have a fair market value which is readily ascertainable."

The initial case to specifically reject negotiability as the determinative test for cash equivalency was *Cowden v. Commissioner*. In 1951 the taxpayers leased a portion of their land to Stanolind Oil and Gas Company, and at that time the company contracted to make "advance royalty" payments to the taxpayers, with one payment due in 1952 and one in 1953. In 1952, the taxpayers assigned the contract right to receive the 1953 payment to a local bank at a nominal discount, and reported a gain on the transaction at that time. The Commissioner contended that the company's obligations to pay resulted in income reportable in 1951—the year in which the taxpayers received them. The taxpayer took the position that there could be no "equivalency of cash" since the obligations to pay were not evidenced by negotiable instruments. The Fifth Circuit rejected the taxpayers' argument as being "as unrealistic as it is formalistic."

The court then added the following comment:

We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the general prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have

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53 VII-1 CUM. BULL. 62 (1928).

54 Id. at 63. More recent cases, however, have been willing to find "fair market value" absent negotiability. For example, in Phillips v. Frank, 295 F.2d 629 (9th Cir. 1961), the Ninth Circuit held that the previous distinction between the negotiability of notes and the nonnegotiable character of rights in contracts for the sale of land was "illusory" with respect to the question of whether the latter is to be treated as an amount realized. See also Joan E. Heller Trust, 24 CCH Tax Ct. Mem. 1663 (1965), where it was stated: "The question is not . . . whether the contracts are negotiable instruments but whether, under the facts on record, we can determine a fair market value for these contracts . . . ." Id. at 1669, rev'd 382 F.2d 675 (9th Cir. 1967). However, in Guffey v. United States, 222 F. Supp. 461 (D. Ore. 1963), aff'd, 339 F.2d 759 (9th Cir. 1964), the district court without mention of Phillips v. Frank concluded that a contract for the purchase of land was not a cash equivalent, since they are not freely traded and are ordinarily sold only at substantial discounts.

55 289 F.2d 20 (5th Cir. 1961).

56 Id. at 24.
been taxable had it been received by the taxpayer rather than the obligation.\textsuperscript{57}

The \emph{Cowden} court seems to be applying "cash equivalency" as the appropriate standard. All of the factors mentioned above clearly indicate that the taxpayer could, without great difficulty, convert the promise into immediate cash.

Although \emph{Cowden} does reject negotiability as the determinative factor for present recognition, courts have not relied upon this decision for the proposition that negotiability is \emph{never} the determinative factor. The essence of the holding is that receipt of unsecured, unconditional and nonnegotiable promises of a solvent debtor to make future payments results in taxable gain. However, the holding should probably be limited to the particular set of facts involved. That is, there were a substantial number of other relevant factors which were present in \emph{Cowden}: (a) the solvency of the obligor;\textsuperscript{55} (b) the unconditional and assignable aspects of the promise;\textsuperscript{52} and (c) the transferability of the promise at a reasonable discount.\textsuperscript{60} The presence of these factors was sufficient to negate the importance of the lack of negotiability. However, in simple executory contracts to make future payments unsupported by notes, mortgages or other evidences of indebtedness, the contract rights are generally not valued and are viewed merely as accounts payable by the buyer and accounts receivable by the seller.\textsuperscript{61} In the absence of the \emph{Cowden} factors listed above this is generally the proper method to account for such contracts.\textsuperscript{62} Thus it is now generally accepted under both the "cash equivalency" and "fair market value" standards, that receipt of a promise to pay constitutes taxable income to the cash basis taxpayer if it is capable of being readily converted into cash. Lack of negotiability no longer stands as an independent ground for deferral of taxation.

\textsuperscript{57} \textit{Id.}
\textsuperscript{56} \textit{Id.} It should be pointed out that solvency of the obligor is also an important factor in determining the fair market value of a \emph{negotiable} instrument. \textit{See} Emanuel E. Falk, 36 T.C. 292 (1961) and text accompanying notes 91-96 infra.
\textsuperscript{55} 289 F.2d at 24.
\textsuperscript{52} \textit{Id.}
\textsuperscript{60} \textit{See} Harold W. Johnston, 14 T.C. 550 (1950); William J. Wineberg, 20 CCH Tax Ct. Mem. 1715 (1961), \textit{aff'd}, 326 F.2d 157 (9th Cir. 1963).
\textsuperscript{61} \textit{Id.}
\textsuperscript{62} However, an open account or even a mere oral promise to pay, although not to be regarded as income under the doctrine of cash equivalency, may be found to be constructively received if the amount is shown to have been available to the taxpayer. \textit{See} John B. Atkins, 9 B.T.A. 140 (1927), \textit{aff'd}, 36 F.2d 611 (D.C. Cir. 1929).
2. Transferability and Assignability.—Transferability and assignability are two further liquidity-type factors. The degree of transferability and assignability that must exist before a taxpayer is required to recognize gain may differ depending on which standard the court chooses to apply. For instance, the Treasury has stated that contractual rights must be "freely transferable and readily saleable" before an obligor's promise can be considered the equivalent of cash. However, minimum restrictions on assignability will not necessarily justify nonrecognition, especially if the "fair market value" standard is applied. In Levine v. Commissioner, for example, the restriction on assignment for a maximum period of one year, to be released earlier if examination of the seller's books were completed, did not prevent purchase money mortgages from being assigned a fair market value equal to face.

Use of the "cash equivalency" standard obviously makes deferral of taxation more likely. However, under either standard, the existence of assignability in form only will probably not be sufficient to defer recognition of gain. The taxpayer must be able to utilize the assignable nature of the instrument. Absence of a potential assignee may be an important factor. Furthermore, it has been specifically held that if freely assignable notes are held in escrow and the seller has no right to immediate possession of the notes, then the factor of free assignability is irrelevant to the determination of immediate recognition of gain.

3. Marketability.—The existence of a market place for contractual rights or obligations unsupported by negotiable notes is generally held to warrant the conclusion that such rights or obligations are the equivalent of cash or have an ascertainable fair market value. Three related concepts have been advanced which aid in establishing what evidentiary criteria may be presented in determining whether a market place exists for a specific obligation.

(a) Regular Trading. In Curtis R. Andrews, the taxpayer, upon the sale of his partnership interest, received contractual rights unsupported by notes and unsecured. Subsequent to the sale the tax-

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64 324 F.2d 298 (3d Cir. 1963).
65 See text accompanying notes 67-75 infra.
66 McLaughlin v. Commissioner, 113 F.2d 611 (7th Cir. 1940). Of course, if the taxpayer insists on the use of escrow to defer recognition of income, the doctrine of constructive receipt may require immediate recognition.
payer had made several fruitless attempts to sell the rights locally. The controlling factor in the court's determination that the contractual rights were not cash equivalents was the fact that they were not of a type "commonly sold."

Evidence as to presence or absence of common or regular trading in the specific type of obligation, then, may be pertinent. The implication of the Andrews case, due to its particular facts, is that absence of regular trading in the immediate locality may be sufficient. However, absence of local regular trading has been deemed insufficient in at least one case. In C.D. Stratton, a promissory note secured by a second mortgage was received by the taxpayer upon a corporate liquidation. Notwithstanding the fact that there were no institutions located in the taxpayer's hometown, Boise, Idaho, which engaged in the purchasing of second mortgage notes, the notes were deemed to have an ascertainable fair market value. It was possible to ascertain their fair market value, explained the court, since there were corporations and other institutions in other western states, particularly California, which engaged in the purchasing of such notes.

(b) The Cowden test. Cowden v. Commissioner stated that to be a cash equivalent a contractual promise must be of a type which is "frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money." This adds a further element to the concept discussed above. Once evidence of regular trading is presented it may be accompanied by evidence as to the amount of discount offered by the regular traders on the specific type of promise as well as evidence as to the present standard amount of discount. If the disparity is significant, the Cowden test suggests lack of cash equivalency.

Questions relating to the extent of discount will be discussed in more detail at the end of this Section and again in Section IV. The notion is offered here simply as a possible evidentiary factor in an attempt to establish that there is in fact no market for a particular

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68 Id. at 1035.
70 See also Joliet-Norfolk Farm Corp., 8 B.T.A. 824 (1927), acquiesced in, VII-1 Cum. Bull. 16 (1928) where the court found second mortgage notes to have no fair market value. The findings of fact indicated the scope of the search for a market place was extended beyond the taxpayer's hometown.
71 289 F.2d 20 (5th Cir. 1961).
72 Id. at 24.
obligation. Obviously the fact of a substantial discount alone will normally be insufficient to establish absence of fair market value. The reasons for the discount must also be analyzed. However, expert witnesses testifying as to the amount of discount they would be willing to offer has been considered of probative value by some courts.\textsuperscript{73}

(c) Readily Marketable and Immediately Convertible. The third concept is reflected in the following language from the Treasury Department:

Certain evidences of indebtedness are property deemed to be equivalent of cash, but not all evidences of indebtedness are property the fair market value of which is includable in the income of a taxpayer on the cash receipts and disbursements method of accounting. However, a deferred-payment obligation which is readily marketable and immediately convertible to cash is property the fair market value of which is income to a cash-method taxpayer in the year of receipt to the extent of that fair market value.\textsuperscript{74}

The type of evidentiary criteria suggested by this language is similar to that suggested by the first two concepts. "Readily" and "immediately" may imply a geographically local market as suggested in \textit{Curtis R. Andrews.}\textsuperscript{75} Both terms suggest a degree of transferability which approaches negotiability. On the other hand, the language does not logically require nonrecognition if something less than negotiability is present. It does, however, emphasize the fact that it is the \textit{current} marketability of the obligations which renders them equivalent to cash. The possibility that a market place may exist at some time in the future, even if that possibility approaches certainty, would not be sufficient if evidence were presented to establish the absence of ready marketability and immediate convertibility.

4. Contingencies.\textsuperscript{76}—Discussion of the first three factors has il-
illustrated the modern trend toward finding fair market value for promises to pay. However, in some cases there are sufficient contingencies which give rise to open rather than closed tax treatment. The Supreme Court has refused to ascribe a fair market value to an obligation or promise to pay in the future which is so contingent upon future economic events and uncertainties as to render any method of valuation highly speculative. The leading case in this area is *Burnet v. Logan.*

Mrs. Logan owned stock in a company that had certain mining interests. In 1916 she sold her stock and in the transaction she received a promise to pay sixty cents per ton of ore mined in the future. The Commissioner attempted to treat the sale as a closed transaction by placing a fair market value on the promise. The taxpayer argued that the promise had no ascertainable fair market value and that she was entitled to "open" treatment. The Court agreed with the taxpayer.

*Burnet v. Logan* involved a contingency which affected the face amount, since the amount of payment was based on the tonnage of ore that would be mined in the future. However the case does not stand for the proposition that a promise to pay an indefinite amount necessarily has an unascertainable fair market value, as some commentators have suggested. "There is nothing inherent in a contract or claim for the future payment of indefinite amounts that causes it to be insusceptible of valuation." Thus it would be possible for a transaction involving an indeterminate sales price to be taxed according to the "closed" method even though it were properly classified as an "open" transaction. "Closed" treatment would be required if the obligation, although "open" as to face amount, had a readily ascertainable fair market value. Such would be the case, for example, were the obligation to state that the amount due would be five per cent of Company A's yearly profit. If Company A had a fairly uniform history regarding yearly profits and if such obligations were regularly traded at a fair value, it would be possible to ascertain the obligation's "fair market value."

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factors merely imply contingencies; payment is impliedly contingent upon the obligor's ability to pay. Express contingencies may prevent the payment from ever becoming due, whereas implied contingencies merely operate to prevent payment in a practical sense.

77 283 U.S. 404 (1931).


In *Burnet v. Logan*, however, it was not the "openness" of face amount alone which required "open" treatment. Rather, the contingency as to face amount was coupled with a particular factual situation which made the value of the obligation even more speculative. The relevant facts in *Burnet v. Logan* were that the amount of ore available for mining was unknown and that the mining company was under no obligation to extract any ore at all.\(^8\)

The rule of *Burnet v. Logan* has been applied to other types of contingent payments. In *George W. Potter*,\(^8\) the promise was for a fixed payment, but it was contingently payable out of future profits from a mining operation. The court found that the promise had no ascertainable fair market value in the year of sale because the taxpayer presented sufficient evidence to show that at best the possibility of his realizing any gain in the transaction was highly speculative.\(^8\) In *Donald C. MacDonald*\(^8\) payments to the taxpayer were contingent upon royalties produced under certain patent rights. Again, the court looked to the particular factual situation and determined that there was sufficient uncertainty regarding the amount of gain that the taxpayer might actually realize from the transaction.\(^8\) Therefore, "open" treatment was appropriate.

Although promises to pay that are contingent on future profits have been held to have no ascertainable fair market value,\(^8\) there is an exception to the general rule of *Burnet v. Logan*. If there are conditions prevalent in the particular industry concerned that make future success speculative, that may be sufficient evidence of lack of present fair market value of any obligations which are contingent upon such future success.\(^8\) But if there is "an established industry with sufficient criteria for ascertaining fair market value,"\(^7\) then a fair market value may be ascribed in spite of the contingent nature of the payments.\(^8\)

\(^8\) 42 F.2d at 195-96.
\(^7\) 7 CCH Tax Ct. Mem. 622 (1948).
\(^8\) The mine involved had been worked to near exhaustion and evidence as to past profits was not considered indicative as to future prospects. *Id.* at 626.
\(^8\) 55 T.C. 840 (1971).
\(^8\) The court noted that past history of production may be indicative of future production in some cases. But in the instant case such estimations were complicated by the possibility of an expanding market and certain threats to production. *Id.* at 861.
\(^8\) Stephen H. Dorsey, 49 T.C. 606 (1968).
\(^7\) *Id.* at 630.
\(^8\) Exemplary of this *renvoi* to industry for determination of fair market value are the following: (1) valuation of royalty rights in the motion picture industry, Pat O'Brien, 25 T.C.
The Service has attempted to restrict the use of *Burnet v. Logan* to prevent the potential of transmuting ordinary income into capital gains. With the trend toward valuation of contingent payment contracts and with the Treasury’s requirement that such contracts be valued except in “rare and extraordinary cases,” the availability of the open transaction method is becoming more limited.

5. Obligor’s Financial Status.—The financial status of the obligor has, in some instances, been advanced as a factor to be considered in determining the fair market value of notes or obligations, or for that matter, determining whether a fair market value can be ascertained at all. In *D.I. Stevenson v. Commissioner,* the known financial weakness of the purchaser under a contract for the sale of land, as well as the speculative nature of the purchaser’s venture (raising mint commercially in an area where it seemed likely to fail) led the court to conclude that the selling or pledging of the taxpayer’s contractual rights would be difficult if not impossible. Under these circumstances, the court refused to make a finding of cash equivalency.

A more recent case finding the obligor’s financial status to be a factor in ascertaining the existence of a fair market value is *Estate of William F. Stahl.* In this case, the future payments on promissory notes received on the sale of a patented invention depended principally on the productive capacity of the invention. This factor, coupled with a showing of the financial weakness of the obligor, was sufficient to induce the court to conclude that the fair market value of the promissory notes was unascertainable.

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376 (1955); (2) valuation of contract rights to future payments based upon gross receipts from the sale of water, *Gersten v. Commissioner,* 267 F.2d 195 (9th Cir. 1959); (3) valuation of the rights to future renewal commissions in the insurance industry, *Estate of Abraham Goldstein,* 33 T.C. 1032 (1969). The real estate industry has been instrumental in changing the characterization of land sales contracts for tax purposes. Early Tax Court decisions consistently found that contracts for the sale of land were not cash equivalents, reasoning that there was no established market, or that the contract was merely an account receivable. Estate of Wilson Critzer, 13 CCH Tax Ct. Mem. 1037 (1954); Nina J. Ennis, 17 T.C. 465 (1951). However, with the development and use of “standard land sales contracts,” came growing acceptance and marketability in the investment community. Today standard form land sales contracts are normally readily tradable and, therefore, are includible in income to the extent of fair market value. *Kaufman v. Commissioner,* 372 F.2d 789 (4th Cir. 1966).


10 9 B.T.A. 552 (1927).

11 52 T.C. 591 (1969), aff’d, 442 F.2d 324 (7th Cir. 1971).
No case has yet held that a negotiable promissory note would not be a cash equivalent should the obligor be found to have a weak financial status. But the court in Cowden v. Commissioner stated in dictum that “[a] promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency . . . [and therefore] might be denied a ready acceptance in the market place.” Unfortunately, R.V. Board, on which the Cowden court placed great reliance, did not indicate whether the note involved was negotiable. Moreover, no cases were cited where a note, negotiable in form, was found not to be a cash equivalent due to the financial status of the maker.

6. Other Factors.—Several other factors have at times been considered by the courts as relevant to their determination of both the existence of an ascertainable fair market value and the amount of that fair market value. For instance, the value of the property securing a note as well as the extent to which the security may be encumbered by senior liens, have been determinative factors.

The duration of the outstanding debt may also be relevant in ascertaining the existence or the amount of the fair market value of a promise to pay. In Pinellas Ice & Cold Storage Co. v. Commissioner, the short-term character of the notes was a contributing factor in support of the Court’s finding that the fair market value of the notes was equal to face.

The Court’s emphasis on this factor suggests that the notes’ short-term character was not only relevant in determining the amount of the fair market value, but also relevant to the initial determination that there was any fair market value and that, therefore, receipt of

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**Notes:**

1. Solvency of the obligor is, however, an important factor in determining the fair market value of such a note. See note 58 supra.
3. 289 F.2d at 24.
4. 18 B.T.A. 650 (1930).
5. See, e.g., Walter W. Rose Inv. Co., 24 B.T.A. 215 (1931), acquiesced in, X-2 CUM. BULL. 61 (1931), where the taxpayer sold an orange grove for cash and notes secured by a first mortgage on the property. The court in holding that the notes had no fair market value explained that in the year of the sale there was no demand nor any market for purchase money notes secured by mortgages on the type of property involved in the case, because of the existing frost hazard.
6. See, e.g., Miller v. United States, 235 F.2d 553 (6th Cir. 1956), where the second mortgage notes, being subordinated to first mortgage notes to the extent of 90 per cent of the appraised value of the property, were held to have no fair market value.
7. 287 U.S. 462 (1933).
the notes resulted in a recognizable gain. The Court seemed to be applying the "cash equivalency" standard. The short-term character of the notes (all due within four months) was particularly relevant under this analysis, since there is obviously less distinction between short-term notes and present cash than between present cash and cash in ten years time. The question arises: Does the long-term character of an obligation suggest that recognition of gain should be deferred altogether? The Pinellas case implies that such might be the case. Assuming the obligation to be transferable, the long-term character would probably serve merely to reduce the present fair market value. The propriety for deferment of gain in such a situation will be analyzed in Section IV.

All of the above factors should be considered collectively in determining fair market value in deferred payment sales of property. Presence or absence of any single factor should not normally be determinative of the issue of whether the transaction is "closed" for tax purposes, requiring the taxpayer to recognize immediate gain. However, absence of most or all of the factors will often make the transaction "open" for the cash basis taxpayer, thereby allowing him to defer recognition of gain.

III. Accrual Basis Taxpayers

A. General Introduction

Prior to 1916 the only authorized method for computing taxable income was the cash receipts and disbursements method.\textsuperscript{103} After the enactment of section 8(g) of the Act of 1916,\textsuperscript{101} however, an individual was allowed to "make his return upon the basis upon which his accounts are kept. . . ." The present authority for reporting taxable income on the accrual method is found in section 446\textsuperscript{102} and the regulations promulgated thereunder. In particular, Regulation 1.446-1(c)(ii) is pertinent:

Generally, under an accrual method, income is to be included for the taxable year when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.\textsuperscript{103}

\textsuperscript{103} See United States v. Anderson, 269 U.S. 422, 438 (1926).
\textsuperscript{101} Act of September 8, 1916 ch. 463, §8(g), 39 Stat. 763.
\textsuperscript{102} INT. REV. CODE OF 1954, §446.
\textsuperscript{103} Treas. Reg. § 1.446-1(c) (ii) (1957).
Thus the proposition has been established that it is the "right to receive and not the actual receipt"\textsuperscript{104} that determines income tax liability for the accrual basis taxpayer.

There are, of course, exceptions to the general rule that an accrual basis seller must immediately accrue all obligations received in a deferred payment sale of property. For example, accrual of the value of a note may not be required if there is sufficient doubt as to its collectibility.\textsuperscript{105} \textit{Corn Exchange Bank v. United States}\textsuperscript{106} is the case generally cited for this proposition. The taxpayer in \textit{Corn Exchange} argued that he should not be required to accrue interest that became due in a particular taxable year because events in that year made it fairly certain that the obligor would not be able to pay the amount due. The court agreed with the taxpayer, reasoning that it would be unjust to require a taxpayer to pay a tax on an amount that he would in all probability never receive.

Doubt was cast on this "exception", however, by the Supreme Court decision in \textit{Spring City Foundry Co. v. Commissioner}.\textsuperscript{107} \textit{Spring City} is the case generally cited for the proposition that it is the "right to receive and not the actual receipt"\textsuperscript{108} that is determinative of accrual basis tax liability. The issue in \textit{Spring City} centered on whether an account which was due and payable in the year of sale could be excluded from gross income in view of the fact that the account was partially uncollectible. The Court determined that it was proper to include the amount of the account at full face value since the right to payment had accrued at the time of sale. Any questions as to uncollectibility were to be resolved through application of the appropriate statute governing deductions.\textsuperscript{109} \textit{Spring City}, although dealing with an account receivable which had arisen from the sale of inventory by a merchandiser, has nonetheless been cited

\textsuperscript{101} \textit{Spring City Foundry Co. v. Commissioner}, 292 U.S. 182, 184-85 (1934).
\textsuperscript{102} \textit{Clifton Mfg. Co. v. Commissioner}, 137 F.2d 290 (4th Cir. 1943); \textit{Corn Exch. Bank v. United States}, 37 F.2d 34 (2d Cir. 1930). Although both cases involved the question of accruing interest, the rationale for nonaccrual is equally applicable in cases involving promises to pay.
\textsuperscript{103} 37 F.2d 34 (2d Cir. 1930).
\textsuperscript{104} 292 U.S. 182 (1934).
\textsuperscript{105} \textit{Id.} at 184-85.
\textsuperscript{106} The reason the problem arose in this case was that under the taxing statutes then in force, deductions were allowed only for totally worthless debts. Since the debt in question was only partially worthless, the taxpayer argued that the amount should not be included in gross income to begin with. Such a problem would not arise under current taxing statutes since a merchandiser would normally avail himself of a deduction based on his reserve for bad debts. \textit{Id.}
as controlling authority for immediate accrual at face value of installment obligations received in casual sales of non-inventory property.\textsuperscript{10}

The rule expounded in \textit{Spring City} may appear to overrule \textit{Corn Exchange} and cast doubt on the availability of the "uncollectibility" exception. \textit{Corn Exchange}, however, has been followed regularly, notably in cases involving accrual of interest in the year interest becomes legally due.\textsuperscript{11} Perhaps the two cases can be reconciled by focusing on the time the doubt as to collectibility arises. If the seller obtains an unconditional right to future payments and at that time reasonably expects the obligation to be paid, then he must accrue the full amount. If, however, at the time of receipt of the obligations there is sufficient doubt as to collectibility, then under the \textit{Corn Exchange} doctrine the taxpayer would not be required to accrue any amount even though his right is unconditional.\textsuperscript{12} On the other hand, if events follow which cast sufficient doubt on the collectibility of payments, the correct method of accounting for such events under the \textit{Spring City} doctrine is through a proper deduction.\textsuperscript{13} In either case, the mere fact that there is a possibility that the obligor will default in his obligation is not sufficient to defer accrual of the income.\textsuperscript{14} Where there is doubt as to collectibility which is not sufficiently great to prevent accrual, the normal manner of reflecting the doubt is through an addition to the reserve for bad debts.\textsuperscript{15}

Although doubtful collectibility may provide an exception to the general rule of immediate accruability, it is unclear whether there is a similar exception to the general rule that obligations must be accrued at face value. The cases that purport to lay down this latter rule\textsuperscript{16} seem to overlook the fact that section 1001\textsuperscript{17} makes no dis-

\textsuperscript{10} Western Oaks Bldg. Corp., 49 T.C. 365 (1968); First Sav. & Loan Ass'n, 40 T.C. 474 (1963).

\textsuperscript{11} See generally Annot., 150 A.L.R. 754 (1944).

\textsuperscript{12} In Clifton Mfg. Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943), the Court of Appeals for the Fourth Circuit, after citing both \textit{Spring City} and \textit{Corn Exchange}, stated that the present decision was "in harmony with the principle of accrual accounting which regards the right to receive, accompanied by collectibility, as the criterion." 137 F.2d at 292 (emphasis added).

\textsuperscript{13} The Court in \textit{Spring City} states "if such accounts receivable become uncollectible, in whole or in part, the question is one of the deduction which may be taken according to the applicable statute." 292 U.S. at 185 (emphasis added).

\textsuperscript{14} First Sav. & Loan Ass'n, 40 T.C. 474, 478 (1963).

\textsuperscript{15} MERTENS, LAW OF FEDERAL INCOME TAXATION, § 12.75 (rev. ed. 1967).

\textsuperscript{16} See note 110 and accompanying text supra.

\textsuperscript{17} INT. REV. CODE OF 1954 § 1001.
tinction between cash and accrual basis taxpayers. A literal application of this section would allow accrual basis taxpayers to treat the receipt of promises to pay as the receipt of "property (other than money)" and report gain only to the extent of the fair market value of the promises. Possibly the cases have read the Supreme Court decision in *Spring City* as an indication that since the two types of accounting methods are to be distinguished, it would be improper to interpret section 1001 in this manner. One case resolved the problem by stating:

An accrual basis taxpayer does not treat an unconditional right to receive money as property received, but rather as money received to the full extent of the face value of the right.

If the foregoing cases are accepted as controlling, the accrual basis taxpayer who receives installment obligations on the sale of property will as a general rule be required to recognize immediate gain to the extent of the full face amount of the obligations. It should make no difference that the obligations do not become due and payable until some future date. An accrual basis taxpayer, according to such an analysis, would be liable to pay tax on $10,000 even though under the terms of the obligation, he has no right to receive the cash for another ten years and even though he may be unable to convert the obligation into $10,000 cash.

Thus it is difficult for an accrual basis taxpayer to argue that under the "closed" method, he should only be required to accrue the fair market value of any obligations he receives. It is also more difficult for him to argue that the obligations have no fair market value thereby affording him "open" treatment on a deferred payment sales transaction.

### B. Deferred Payment Sales and the Accrual Basis Taxpayer

Regulation 1.453-6(a) provides as follows:

1. In . . . sales of real property involving deferred payments

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118 It has been suggested that the early legislative history of the predecessor of section 1001 suggests a Congressional intent "to impose a uniform rule for the computation of gain or loss on casual sales of personal property and all sales of real estate without regard to the taxpayer's method of accounting, so that all 'obligations of the purchaser' would be valued for cash basis and accrual basis taxpayers alike." Levin & Javaras, *Receipt of Notes and Other Rights to Future Payments by a Cash-Basis Taxpayer*, 54 A.B.A.J. 405, 406 (1968).

119 First Sav. & Loan Ass'n, 40 T.C. 474, 487 (1963).

120 Of course if the transaction qualifies for "installment method" treatment, the accrual basis taxpayer also has that option available for reporting his gain. See note 21, supra.
in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value. . . .

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess.121

Paragraph one describes the appropriate tax consequences of a "closed" transaction. Its importance lies in the fact that if it is applicable to accrual basis taxpayers then the accrual taxpayer is only required to recognize gain to the extent of the fair market value of any obligations he receives. Paragraph two, on the other hand, describes the availability of the "open" transaction method. The phrase "no fair market value" should be interpreted to mean "no ascertainable value."122 The regulation itself makes no distinction between cash and accrual method taxpayers.

The question as to the applicability of this regulation to accrual basis taxpayers was first raised in C. W. Titus, Inc.123 In this case, the taxpayer sold oil and gas leases under an executory contract providing for payment of fifty percent of the sales price at the time of the actual sale, a date which had not then been determined. The balance of the payments due were to be made in the year following the sale. The Board of Tax Appeals originally held that an accrual basis taxpayer was required to report all income represented by the face amount of deferred payment obligations, regardless of their fair market value. The Board alternatively held that the taxpayer had failed to establish any absence of fair market value.

On reconsideration, the Board held that an accrual basis taxpayer has the right to report income on the basis of the deferred payment method prescribed in the regulation. The issue then centered on the question of the fair market value of the deferred payments involved. Since the only evidence of the buyer's obligation to pay was contained in an executory contract which, because of the undetermined sales date, did not indicate when, if ever, the purchaser would become bound to make payments, the Board further con-

121 Treas. Reg. § 1.453-6(a) (1958).
122 See note 12 supra.
123 33 B.T.A. 928 (1936).
cluded that the promise to pay had no fair market value. The lack of marketability of the contract was analyzed in terms of the seller's inability to convert it into cash, seemingly an application of the old "cash equivalency" standard. However, the decision also emphasized the conditional or contingent nature of the promise.

The essence of the Titus decision is that accrual basis taxpayers may utilize the deferred payment method of reporting gain as prescribed by the regulation. Titus, however, involved the applicability of the regulation only insofar as "open" transactions are concerned. The case does not answer the question of the extent to which an accrual basis taxpayer must report gain in a "closed" transaction. Furthermore, it is not clear whether this method is available only in sales of realty as indicated by the regulation since the decision did not clearly state whether the taxpayer had sold real or personal property. Although subsequent cases have considered the applicability of the regulation, the present status of the law in this area is still unclear.

This lack of clarity in the law results mainly from the courts' failure to analyze and apply precedent correctly. It also stems from the fact that the major cases dealing with this question have involved accrual basis taxpayers who were attempting to defer gain by reporting on the "open" method. Thus their arguments have been directed toward establishing either no fair market value or no ascertainable fair market value for the obligations received and not towards establishing that the fair market value was merely less than face. Nonetheless, courts have readily found a fair market value of face amount in cases involving the question of whether there was any fair market value at all.\(^\text{124}\)

The problem is that if a court finds the taxpayer has not met his burden of proving the obligation has a value of less than face, neither paragraph one nor two of the regulation applies. Hence some courts have purportedly held that paragraph one does not apply to an accrual method taxpayer where the taxpayer was arguing for "open" treatment under paragraph two. In such a case the "holding"—that an accrual basis taxpayer may not rely on paragraph one to value an obligation at fair market value rather than face—should be regarded as dictum. Yet such dictum has been blindly followed by other courts. The following discussion illustrates this lack of judicial analysis and its concomitant contribution to the present

\(^{124}\) See, e.g., note 127 infra, and accompanying text.
lack of clarity in the law.

1. Sales of Personal Property.—In George L. Castner Co., the taxpayer sold equipment and machinery in exchange for cash and an interest-bearing note payable over a period of ten years. Cash received in the year of sale exceeded thirty percent of the selling price. Since this made the installment method unavailable to the taxpayer, he argued that the deferred payment regulation as to "open" treatment should be available to him, notwithstanding the fact that the transaction in question was a sale of personal property. The court rejected his argument and treated the transaction as "closed."

The court noted that Titus purported to lay down the rule that an accrual basis taxpayer might compute his gain on the sale of personal property according to the method prescribed by the deferred payment regulation. However, Titus was not deemed controlling since the Titus court had analyzed the transaction as a sale of realty, indicating that any inclusion of personal property in the conveyances to be made was purely incidental to the sale of the real property interests in the oil and gas leases.

The decision in Castner, however, did not turn on the applicability of the regulation. The taxpayer claimed that the note had no fair market value, and thus attempted to report gain on the open transaction method. However, the court found "that the evidence... falls far short of any showing that the note had no fair market value when received, and further, is neither persuasive nor convincing that the value of the note was substantially, if any, less than face...".

Subsequent courts appear to have been misled in their interpretation of Castner. Relying solely upon Castner for its case law authority, the Sixth Circuit stated that "[t]he regulation [1.453-6(a)] relied on by the taxpayers is applicable by its terms only to deferred payment sales of real property, and has been held not to extend to sales of personal property by the accrual basis taxpayer." In George E. Freitas, it was observed that "there is not authorization in the statute [section 453] or the regulations for taxpayers on an accrual basis to report gain from a casual sale of personal property

123 30 T.C. 1061 (1958).
124 Id. at 1070.
125 Id. at 1069.
126 Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766 (6th Cir. 1968).
... on the deferred payment method. A taxpayer on the accrual basis must either accrue the gain on the sale or report it on the installment basis." Again *Castner* was cited as authority for this proposition.

Although the above cases ostensibly have settled the question of the availability of the deferred payment regulation to accrual basis taxpayers on a sale of personal property, the later decisions are subject to attack on the basis of their interpretation of *Castner*. Although *Castner* discussed the applicability of the regulation, the decision should only be cited as authority for the proposition that, absent sufficient evidence to the contrary, a note which bears interest at a sufficient rate has a fair market value equal to its face amount. None of the cases fully consider the rationale behind allowing deferred payment treatment to accrual basis taxpayers only in cases of real property transactions. Nor do they consider the possibility that authority for such tax treatment may be found somewhere outside Regulation 1.453-6(a)—in section 1001, for example.

2. Sales of Real Property.—The state of the law with regard to the availability of the deferred payment regulation for sales of real property by an accrual basis taxpayer is also unclear. Although the regulation itself makes no distinction between cash and accrual basis taxpayers, courts which have addressed themselves to this issue have taken it upon themselves to draw a distinction. *First Savings & Loan Association*, although not directly facing the issue, stated in a footnote that since the taxpayer had not elected to use the installment method, he was required to report the full amount of gain in the year of sale. The implication of this statement raises another question as to the applicability of the regulation. Since the language expressly refers to sales of real property "in which payments received during the year of sale exceed thirty percent of the selling price," the regulation might be interpreted as being limited to those sales which do not qualify for installment treatment. That is, mere failure to elect, when the installment method is otherwise available, may not be sufficient for utilization of the deferred payment treatment afforded in the regulation.

120 *Id.* at 555.
121 It has been suggested that the reason for the restriction may be that obligations to pay for real property are usually for a greater amount of money and may remain outstanding for a longer period. *See Note, supra* note 12, at 103.
123 *Id.* at 487 n.7.
First Savings & Loan Association expressly stated that the accrual basis taxpayer could not avail himself of section 1001 and claim only the fair market value of the obligations as an amount realized. However as with Castner, the ultimate reason for ruling against the taxpayer was that he had failed to establish the obligations were worth any less than their face amount.

Despite the fact that First Savings & Loan Association did not address itself directly to the issue of the applicability of Regulation 1.453-6(a) to accrual basis taxpayers, it was cited as authority for the inapplicability of the regulation in Western Oaks Builders Corp. Although the taxpayer in Western Oaks did not argue the applicability of the regulation, the court stated that in sales of property an accrual basis taxpayer must accrue the face amount of any obligations received, rather than the fair market value. The court itself pointed out the existence of the regulation and held it inapplicable to accrual basis taxpayers.

Western Oaks relies heavily on the Spring City analysis of accrual basis accounting. Since the right to payment normally accrues at the time of sale and since the right to payment is not in any way dependent on the factors that may affect fair market value, reliance on the Spring City analysis naturally tends to exclude the use of fair market value for the accrual basis taxpayer. However Spring City involved open accounts immediately due and payable, not accounts represented by deferred payment obligations. Thus Spring City in no way contradicts the proposition that Regulation 1.453-6(a) is applicable to accrual basis taxpayers since it did not specifically deal with that issue. The Western Oaks court should have limited Spring City to its facts rather than relying on it for a broader proposition.

IV. Open v. Closed and Fair Market Value: Final Analysis
A. Open Transactions

If a taxpayer qualifies for “open” treatment, it makes no difference whether he reports gain on the accrual method or the cash method. The mechanics of the “open” method will be the same. Payments received first reduce basis and after the basis has been recovered, the remaining payments are reported entirely as gain. The only consideration given to accounting methods is in the initial

determination of whether "open" treatment is available. For cash basis taxpayers, the determination is made on the basis of whether any fair market value exists, or whether it is ascertainable, for the deferred payment obligations he receives. This determination, in turn, is based on the presence or absence of the relevant factors discussed in Section II. As there pointed out, the determination may be affected by which standard for realizing gain under section 1001 the court chooses to apply. If the court strictly adheres to the "cash equivalency" standard, then absence of the liquidity-type factors or the presence of significant contingencies may make it impossible for the seller to convert an obligation into cash. Thus no gain would be realized. Under the "fair market value" standard, there are several possible arguments for concluding that there has been no realization. First, if there is no possible market, then there is no objective source from which the amount realized—and therefore the gain—can be derived. Second, the presence of substantial contingencies will normally make "open" treatment available for the cash basis taxpayer on the theory that the fair market value of the obligations cannot be ascertained. Third, an obligation subject to substantial contingencies may not qualify as "other property" under section 1001. That is, the contingencies may prevent the seller from having enough of a vested right to future payment to classify the promise as any kind of property at all.

Presence or absence of these factors or contingencies is not normally determinative of the tax liability of an accrual basis seller. A bare right to future payment, regardless of whether that right has any fair market value, is all that is generally necessary for him to realize the gain represented by deferred payment obligations. But the factors or contingencies which would make it impossible for the cash basis taxpayer to estimate the amount of his gain would seem to render an estimate of gain for the accrual basis taxpayer equally speculative. For this reason there should be no distinction made between accounting methods in transactions that involve deferred payment sales. This is especially true in the case where "contingencies" are involved. Under the Spring City analysis, it might be argued that the contingency prevents the right from becoming "fixed." Or the contingency may prevent the amount from becoming "fixed"—another prerequisite for accrual.133

However, it must be kept in mind that a payment which is merely

contingent in form does not automatically result in "open" treatment. The contingency must operate in a factual situation which makes it impossible to estimate gain with any reasonable degree of accuracy.

B. Closed Transactions

Once it has been determined that a fair market value exists, the cash basis taxpayer must report gain according to the closed transaction method. The accrual basis taxpayer must do so once his right to a specific amount becomes fixed. The question then becomes—should cash and accrual basis taxpayers be treated differently when receipt of a deferred payment obligation requires "closed" treatment?

Regulation 1.453-6(a)(1) which prescribes the method of reporting gain on a closed transaction makes no such distinction. However its application may be limited to sales of realty, and then only to those sales which do not qualify for installment treatment. The problems presented by judicial interpretations of this regulation have already been discussed. The real issue is whether there is any logical basis for treating the two types of taxpayers differently in such a situation. That is, the question is—why should accrual basis taxpayers be required to report income to the extent of the face value of obligations received, whereas cash basis taxpayers are required to report income only to the extent of an obligation's fair market value?

The factor of "time to maturity" is a major consideration in ascertaining the present fair market value of any obligation. A discussion of this factor will serve to point out the potential inequity of refusing to allow the accrual basis taxpayer to report gain on receipt of a promise to pay only to the extent of its fair market value.

If the note involved is accompanied by a sufficient interest rate, the duration of the outstanding debt is not particularly significant. Since a "sufficient interest rate" represents the amount of return the note holder would be likely to earn were he to invest the money elsewhere, the difference between present cash and future cash is minimal. Furthermore, absent restrictions on transferability the holder should be able to realize the face amount of the note immediately if he so wished. Receipt of such notes by cash or accrual basis taxpayers should result in immediate recognition computed on the basis of face value.

On the other hand, if the note bears no interest whatsoever, the longer the time to maturity, the less the present value of the note
will be. The discount factor will be directly related to, among other things, present rates for the use of money. Time to maturity alone could be said to reduce the value of a $1,000 marketable note due in ten years, but bearing no interest, to approximately $500 since $500 invested at seven percent today would increase to an investment of $1,000 in ten years time. If a cash basis seller were to receive such a note, he would be required to report that receipt for tax purposes as though he had received $500 cash. However under the Spring City analysis, if he were an accrual basis seller, he would be required to report the full $1,000 face value, because his right to that amount is fixed.

The above example serves to isolate the single issue: Should an accrual basis taxpayer be required to accrue an obligation at face value if, for example, absence of an interest rate, coupled with a distant maturity date, causes the obligation to be worth much less than face? Normally an accrual basis taxpayer can account for the discount reflected by an unsound obligor or other collectibility doubts through an addition to his bad debt reserve. But is there any comparable deduction for loss of interest on the outstanding debt? It may be argued that section 483 will apply in such a case and that on the basis of the imputed interest rules the accrual basis taxpayer is only liable to accrue the present value of the obligation. This raises several problems. Is he also liable to accrue the imputed interest? Or may he defer accrual until the payment is made in year ten? Or should he perhaps accrue an appropriate amount each year as that amount is constructively earned by the passage of time?

Furthermore, section 483 does not apply to all deferred payment transactions. Nor was it enacted for the purpose of allowing accrual basis taxpayers similar treatment to cash basis taxpayers. There is, then, no specific provision for a deduction which reflects loss of interest on an outstanding debt; and it is improbable that the Commissioner would favor an "implied" deduction.

In such a situation there is simply no rationale for requiring the accrual basis seller to accrue the face amount. Spring City should be distinguished on its facts. Normally accrual basis taxpayers are sellers of inventory property. Sales are made on open account and receivables are due within a short time span. Although emphasis has been placed on the fact that it is the time the right accrues that

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\*124 It does not apply, for example, to sales in which the sales price is less than $3,000, nor does it apply to sales of patents. Treas. Reg. § 1.483-2(b)(1966).
is important and not the time the payment becomes due, a distinction should be made. The right to receive $1,000 immediately or in the near future is inherently different from the right to receive $1,000 in ten years time. The time the right accrues may be properly determinative of the time when it is proper to accrue income. But the time the payment becomes due may be determinative of the amount that should be accrued.

There is no sound basis for treating cash and accrual basis taxpayers any differently in such a situation. The accounting method employed by the taxpayer is normally determinative of the year in which income is to be reported. The method need not also be determinative of the amount of taxable gain a taxpayer is required to report. Neither section 1001 of the Revenue Code nor Regulation 1.453-6(a) distinguishes between cash and accrual basis taxpayers. Both are explicit authority for valuing promises to pay at fair market value. If the facts warrant assigning a particular promise a value of less than face, then the facts should be further analyzed before applying the rigid rule requiring accrual basis taxpayers to accrue at face value. Doubt as to collectibility may be offset through the bad debt reserve. However, time to maturity and an insufficient interest rate may not be. If these are the factors which reduce the value of the promise to an amount less than face, the foregoing analysis supports the proposition that it is this lower value which should be accrued.

V. CONCLUSION

"Deferred payment sales" is but one area in which questions arise as to the taxation of promises to pay. It is an area which appears to have created different tax consequences for cash and accrual basis sellers. There are many factors which have contributed to this distinction and it has been suggested that perhaps this distinction is not always justified. Inconsistencies have arisen because courts have been inclined to apply rigid rules without analyzing the bases for their application and without considering the context out of which particular rules have arisen. The most apparent confusion stems from a blind application of the Spring City doctrine to all accrual basis taxpayers. It is possible that deferred payment sales create an exception to normal tax accounting procedures. Since regulation

138 See Treas. Reg. § 1.446-1(c) (1957).
1.453-6(a) is the only specific reference to deferred payment sales and since it makes no distinction between cash and accrual methods, perhaps it should be interpreted as indicative that deferred payment sales create identical tax liability for both types of taxpayers.