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Revenue Ruling 79-292 and Deferred Reporting

RICHARD L. MEIVES*

When a taxpayer sells property and receives a purchaser's obligation in exchange, the Internal Revenue Service's new reporting rules for cash and accrual basis taxpayers result in inconsistent applications of section 1001(b) of the Internal Revenue Code. In Revenue Ruling 79-292, the Service treats section 1001(b) as being modified by section 451's method of accounting rules; this position subsequently has been incorporated into the temporary regulations under the Installment Sales Revision Act of 1980. The author argues that section 1001(b) operates independently of a taxpayer's method of accounting and that the Service's position creates doctrinal disharmony in the area of deferred reporting.

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I. INTRODUCTION

In Revenue Ruling 79-292, the Internal Revenue Service ruled that when an accrual basis taxpayer sells real property and receives a purchaser's long term note in exchange, the seller's accounting method takes precedence over the language of section 1001(b) in determining the amount to be realized. This ruling limits the availability of deferred reporting for accrual basis taxpayers, while indirectly endorsing the expansion of deferred reporting for cash basis taxpayers.

Revenue Ruling 79-292 concerned an accrual basis taxpayer, engaged in the business of constructing single family houses, that sold a home for $40,000. The buyer satisfied $30,000 of the purchase price with a first mortgage loan from a bank. The taxpayer financed the remainder of the buyer's obligation, taking back a $10,000 second mortgage. No interest or principal payments were due on the second mortgage for fifteen years and, as a result, the obligation's $10,000 face value exceeded its fair market value.

The ruling considered whether, under section 1001(b), the accrual basis seller could defer realization of the excess of the second mortgage's face value over its fair market value. In its analysis, the Service examined the interplay between the fair market value limi-

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2. I.R.C. § 1001(b) states in pertinent part: "Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

All references and citations to sections in this article are to sections of the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated. All references and citations to regulations are to Treasury regulations under the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated.

References to regulations under § 453, other than to the current temporary regulations to that section, are to the versions in force immediately before the enactment of the Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (codified at I.R.C. § 453).

3. Payments on the second mortgage commenced after satisfaction of the first mortgage.

The Revenue Ruling also considered a second transaction where the taxpayer sold a piece of construction equipment and received a purchaser's obligation payable two years in the future. The Service accorded the same treatment to both transactions.
tation in section 1001(b) and the method of accounting rule set out in section 451(a). Section 1001(b) provides that “[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.” Neither section 1001 nor its interpretive regulations refer to a seller’s accounting method as a factor in determining “amount realized.” The Service ruled, however, that a taxpayer’s method of accounting must be considered in determining “amount realized” under section 1001(b) and thus required the taxpayer to realize the face value of the second mortgage in the year of the sale. The United States Treasury Department has adopted Revenue Ruling 79-292’s position in section 15A.453-1(d)(2) of the temporary regulations, promulgated under the Installment Sales Revision Act of 1980 (“Installment Sales Act”).

This article will demonstrate that the Service made several errors in Revenue Ruling 79-292. The Service construed section 1001 too broadly when it found that “[t]he provisions of section 1001 of the Code apply to any sale . . . of property.” The Service failed to recognize the fundamental distinction between inventory and non-inventory sales under the Code and, as a result, it relied on inappropriate authority to support its holding. Additionally, the Service misinterpreted the relationship between section 1001(b) and the method of accounting rules. This relationship will be examined in light of the historical development of both section 1001(b) and the installment method of deferred reporting.

The Service’s position in Revenue Ruling 79-292 and section

4. Section 451(a) states:
   General Rule.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be property accounted for as of a different period.

   The regulations specify when income must be recognized under the cash and accrual accounting methods: “Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received.” Treas. Reg. § 1.446-1(c)(1)(i), T.D. 6282, 1958-1 C.B. 215, 218.

   “Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.” Treas. Reg. § 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164.

5. I.R.C. § 1001(b).


of the temporary regulations creates doctrinal disharmony in the area of deferred reporting. This article's thesis is that section 1001(b) operates independently of a taxpayer's method of accounting. Accrual and cash basis taxpayers should thus treat a purchaser's obligation as an amount realized only to the extent of the obligation's fair market value. The Service allows cash basis taxpayers to report in this manner, but it requires accrual basis taxpayers to treat the face value of a purchaser's obligation as an amount realized, claiming that the taxpayer's method of accounting determines the amount to be realized under section 1001(b). The Service, however, apparently posits that a cash basis taxpayer should treat a purchaser's obligation as an amount realized to the extent of its fair market value even if that obligation is not the equivalent of cash. The Service has recognized that cash equivalency is a valid attribute of the cash method of reporting. Revenue Ruling 79-219, if applied consistently to a cash basis taxpayer, would permit the cash basis taxpayer to defer the recognition of gain if a purchaser's obligation was not the equivalent of cash.

II. DEFERRED REPORTING

A brief preliminary review of deferred reporting will provide the background information necessary for an understanding of Revenue Ruling 79-292. If a taxpayer sells property and receives consideration that exceeds his basis in the property, then he realizes gain to the extent of the excess. Deferred reporting postpones recognition of income on a transaction and the resulting income tax liability. There is theoretical justification for deferred reporting: (1) the seller may receive consideration for a sale over a period of years, and as a result, he may not have enough cash in the year of sale to meet his tax obligation on the entire realized gain, and (2) the seller may receive consideration of such an indeterminate value that it is not feasible to require the seller to compute a gain or loss at the time of the sale.

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8. See infra text accompanying notes 81-115.
A. Installment Method Treatment

Section 453 permits the installment method of deferred reporting, which is available to both cash basis and accrual basis taxpayers. Under the installment method, if a taxpayer receives a promise of future payment in exchange for property, he must postpone realization of gain until receipt of the future payments. Generally, all sellers of real property and nondealer sellers of personal property qualify to report under the installment method if at least one payment will be received after the close of the taxable year in which the disposition occurs. The seller only recognizes gain on payments he actually receives during the year, and the gain realized on each payment is limited to its proportionate share of the gross profit as calculated on the entire contract price. In essence, a portion of each payment received by the seller constitutes gain and a portion represents recovery of the seller's basis.

B. Closed Transaction Treatment

Although fixed payments will be received in the future, a taxpayer may elect under section 453(d) not to use the installment method. When this occurs, both cash basis and accrual basis sellers of real property and nondealer sellers of personal property determine their gain under section 1001. Under section 1001(b), the purchaser's future fixed payment obligation is treated as "property (other than money)" and gain or loss is calculated using the

11. I.R.C. § 453(a), (c). The taxpayer must report using the installment method unless he affirmatively elects out of section 453. I.R.C. § 453(d).
13. I.R.C. § 453(c). Section 453(c) only applies to gains; losses cannot be spread over a period of years under the installment method. See Sacks v. Burnet, 66 F.2d 223 (D.C. Cir. 1933).
14. I.R.C. § 1001 provides in part:
   (a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . .
   (b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.
15. A purchaser's obligation given directly to a seller is assumedly "property (other than money)" within the meaning of § 1001(b). Cf. First Sav. & Loan Ass'n v. Commissioner, 40 T.C. 474, 487 (1963); Haley, The Application of Section 1001 to Deferred Payment Sales of Property, 28 Tax Law. 303, 318 n.70 (1975) (such obligations are cash equivalents for accrual taxpayers).

This article adopts the position taken by the Service in the temporary regulations under the Installment Sales Act. The regulations state that when a taxpayer elects not to report on the installment method,
property's fair market value.\textsuperscript{16} To the extent that the obligations are valued at less than their face amount, the seller defers gain recognition.\textsuperscript{17} The Service has permitted this method of deferring gains, known as closed transaction treatment, only for cash method taxpayers. Revenue Ruling 79-292 bars accrual basis taxpayers from using this deferral method by holding that a taxpayer’s method of accounting supersedes the fair market valuation of section 1001(b). An accrual basis taxpayer must report his gain by including the face amount of the buyer’s obligation. Thus, after Revenue Ruling 79-292, only cash basis taxpayers can use this closed transaction deferral method.\textsuperscript{18}

\section*{C. Open Transaction Treatment}

A seller may also elect out of section 453, deferring even more gain than he could defer under the installment method. This open transaction treatment has traditionally been available in two separate situations: (1) when the purchaser’s obligation is of an indeterminate value because payments under the obligation are conti-
gent on some unpredictable event, and (2) when a cash basis seller receives a purchaser's obligation that is not a cash equivalent. Under open transaction treatment, the taxpayer defers the reporting of gain until he fully recovers his basis. If a taxpayer receives a purchaser's future obligation with no ascertainable value, he can use open transaction deferred reporting treatment regardless of his method of accounting.

In certain situations, a cash basis taxpayer may treat a transaction as open when he receives a purchaser's obligation with a stated face value that is not a cash equivalent. The face amount of the obligation renders the sales price determinate and precludes the taxpayer from enjoying open transaction treatment under a "no ascertainable value" theory. The cash basis taxpayer, however, defers the reporting of gain because the purchaser's obligation is not a cash equivalent. Cash equivalency open transaction treat-


20. See Goldberg, Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980, 34 TAX LAW. 605, 625 (1981); infra text accompanying notes 119-27. Conceptually, this situation is distinct from the situation in Burnet v. Logan, which applies when the obligation has no ascertainable value. In this second situation, the value may be ascertainable but other factors cause the obligation not to be the equivalent of cash.

21. Burnet v. Logan, 283 U.S. at 412. Treas. Reg. § 1.453-6(a)(2) provides: 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. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.


Under the open transaction method, all of the gain retains the character applicable to the underlying asset sold; i.e., if the asset is a capital asset, the gain recognized after the basis is fully recovered is still considered capital gain. This is in contrast to the characterization of collections in excess of basis under the closed method. See supra note 17.


23. Essentially, a purchaser's obligation is not considered to be a cash equivalent when it cannot be readily converted to cash in an amount closely approximating its face value at the time of the sale. For a more complete discussion of the cash equivalency doctrine, see infra text accompanying notes 119-27.
ment is an exception to the general cash basis reporting rule that cash basis taxpayers report gain upon receipt of cash or property; a purchaser's obligation that is not a cash equivalent is deemed to have no fair market value and the transaction is treated as open. Open transaction treatment in this situation is justified not because of difficulties in valuation, but rather because of the practical difficulty of requiring a cash basis taxpayer to report income before the receipt of cash. But open transaction treatment based on a lack of cash equivalency may no longer be available, if it ever was properly applicable, as both the Senate Finance Committee Report accompanying the Installment Act and the temporary regulations under section 453 limit open transaction treatment to circumstances which fit the "no ascertainable value" rationale.

III. REVENUE RULING 79-292 ANALYZED

A. The Service's Reasoning

A breakdown of the analysis in Revenue Ruling 79-292 will highlight the difficulties inherent in the Service's position. In arriving at its conclusion that section 1001(b) must be read in conjunction with the method of accounting rule of section 451, the Service used the following logic: (1) Section 1001(b) applies to all sales of property, including sales in the ordinary course of business and casual sales; (2) it is a "well-established principle that an accrual method taxpayer includes in income amounts which it has a right to receive" (citing Spring City Foundry Co. v. Commissioner); (3) "[C]ourts have consistently refused to allow accrual method taxpayers to accrue only the fair market value of notes received

24. Under this exception, not only are payments not realized until received, but the full basis in the property sold is recovered before any realization of gain.
25. Underlying this treatment of purchaser's obligations is the premise that the method of accounting rule contained in § 451 modifies § 1001(b).
27. Rev. Rul. 79-292 states:
The provisions of Section 1001 of the Code apply to any sale or other disposition of property. There are no indications either in this section or in its legislative history that its application was intended to be limited to a particular type of sale. The regulations specify that section 1001 covers sales in the ordinary course of a taxpayer's trade or business as well as casual sales.
28. Id.
upon a sale of property . . . ."; and (4) section 1.453-6(a)(1) of the regulations has been interpreted by the courts as inapplicable to accrual basis taxpayers. As demonstrated below, the Service's position on each of these four points is open to question.

B. The Scope of Section 1001(b)

The taxpayer in Revenue Ruling 79-292 was a dealer in real property and the Service properly determined that the taxpayer should have calculated its gain on the sale according to section 1001. The Service's statement that section 1001 applies to any sale of property, however, construes the scope of the section too broadly. Section 1001 does not apply to personal property sales made in the ordinary course of business by dealers; instead, Code section 61 and sections 1.61-3(a) and 1.446-1(a)(4)(i) of the regulations govern income reporting for these inventory sales. Section 1001 provides, however, the appropriate provisions for calculating gains on dealer sales of real property because real property is not considered inventory for federal income tax purposes.

Dealers in personal property compute gains under section 61. Section 1.61-3(a) of the regulations deals with business income under section 61(a)(2) and states that: "[i]n a manufacturing [or] merchandising . . . business, 'gross income' means the total sales, less the cost of goods sold . . . ." Section 1.446-1(a)(4)(i) of the regulations provides that in business involving the "production, purchase, or sale of merchandise," inventories must be used in computing taxable income. Additionally, if the business maintains inventories, the business must use the accrual method of accounting. As the above quoted provisions indicate, taxpayers com-

31. Id. at 289.
pute gains arising from inventory sales by subtracting the cost of goods sold from the total amount of sales. This method of calculating gain inherently differs from section 1001’s calculation, which is based on amount realized and adjusted basis. Valuing inventories at the lower of cost or market and costing under the full absorption method have no counterpart in the determination of a property’s adjusted basis.

Thus, contrary to the position taken in Revenue Ruling 79-292, section 1001(b) only applies to casual sales of personal property and all sales of real property. Section 1001(b) does not apply to sales of personal property by a dealer in the ordinary course of business.

C. The Relevance of Spring City

Citing Spring City Foundry Co. v. Commissioner, the Service next contended that “treating a note received as property under section 1001(b) of the Code and valuing it at fair market value is inconsistent with the well-established principle that an accrual method taxpayer includes in income amounts which it has a right to receive.” Spring City does not support this proposition. In Spring City, a taxpayer sold personal property in the ordinary course of business and received unsecured notes in exchange. Later that year, the purchaser had a bankruptcy petition filed against it. The taxpayer argued, inter alia, that aside from any question of a bad debt deduction, it should not have included the sales in income because of the uncollectible debt. The United States Supreme Court, in response to this argument, formulated the well known rule that for accrual basis taxpayers “it is the right to receive and not the actual receipt that determines the inclusion of

43. See I.R.C. §§ 1011-1012, 1016 and the regulations thereunder.
44. The predecessors to the regulations which distinguish inventory sales from casual sales of personal property can be found in Regulation 45 to the Revenue Act of 1918, T.D. 2831, 21 Treas. Dec. Int. Rev. 170 (1919), reprinted in 134 INTERNAL REVENUE ACts OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (B. Reams, Jr. ed. 1979) [hereinafter cited as Reams]. Specifically, the following articles of Regulation 45 show that § 1001 and its predecessors do not apply to inventory sales: art. 23 (bases of computation (of net income)) (as amended 1919), art. 24 (methods of accounting), art. 35 (gross income from business), and art. 1581 (need of inventories). Clearly, § 1001 and its predecessors have never applied to inventory sales.
45. 1979-2 C.B. 287, 288 (citing Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934)).
the amount in gross income." The Revenue Ruling however ignores the Court's emphasis that this rule is derived from the regulations, which require merchandising and manufacturing businesses to keep inventories and compute gross income from "total sales, less the cost of goods sold." The Court stated:

On an accrual basis, the "total sales," to which the regulation refers, are manifestly the accounts receivable arising from the sales, and these accounts receivable, less the cost of the goods sold, figure in the statement of gross income. If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. . . . That is the question here."

As previously demonstrated, section 1001(b) does not govern sales in the ordinary course of business in which inventories must be maintained. Thus, the valuation of a note by an accrual basis taxpayer at its fair market value under section 1001(b) does not conflict with Spring City's "well-established principle" because Spring City only applies to inventory sales of personal property.

D. Other Precedents

The Service next stated in the Revenue Ruling that "[t]he courts have consistently refused to allow accrual method taxpayers to accrue only the fair market value of notes received upon a sale of property . . . ." In support of this statement, the Service cited Jones Lumber Co. v. Commissioner, George L. Castner Co. v. Commissioner, and First Savings & Loan Ass'n v. Commissioner. These cases, however, predicate their holdings on Spring City or other cases outside of the scope of section 1001 and thus do not apply to the situation considered in Revenue Ruling 79-292.

In First Savings the Tax Court based its holding that an accrual basis seller of real property must value purchaser's notes at face value on Spring City and Key Homes, Inc. v. Commissioner. As previously discussed, Spring City is only relevant in an inven-

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46. 292 U.S. 182, 184 (1934).
47. Id. at 185 (quoting Reg. 45, art. 35 (1918)).
48. Id. (citations omitted).
49. See supra text accompanying notes 32-44.
51. 404 F.2d 764 (6th Cir. 1968).
52. 30 T.C. 1061 (1958).
54. 30 T.C. 109 (1958), aff'd per curiam, 271 F.2d 280 (6th Cir. 1959).
tory context. In *Key Homes* section 1001(b)'s fair market value language was not at issue; rather, the court considered whether money held by a mortgagee in a restricted savings account constituted income to the seller.

*Castner* concerned a casual sale of personal property. The Tax Court erroneously relied on *Spring City* in holding that an accrual method taxpayer cannot accrue notes at fair market value when making a casual sale of personal property.55 A casual sale of personal property is not an inventory sale, and therefore the *Spring City* rule should not have been applied to the section 1001(b) issue. The court in *Jones Lumber* essentially relied on the *Castner* decision for its holding that an accrual taxpayer cannot accrue notes at fair market value.56

Other case law supports an interpretation of section 1001(b) contrary to that expressed in Revenue Ruling 79-292. In *C.W. Titus, Inc. v. Commissioner,*57 the Board of Tax Appeals, on its first hearing of the case, found that an accrual basis taxpayer must include the face value of a purchaser's obligations as an amount realized, regardless of its fair market value. Upon rehearing, however, the board found that it had erroneously held that the use of the taxpayer's accounting method determined the inclusion issue. The board further held that an accrual method taxpayer can report gain according to the method prescribed in the predecessor to regulation section 1.453-6(a)(1).58 The board noted that the Commissioner did not question the availability of fair market value reporting, and that the issue had been originally raised by the board.59

E. *Section 1.453-6(a)(1) of the Regulations*

Regulation 1.453-6(a)(1) appears to allow an accrual basis seller of real property to report a purchaser's obligation at fair

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55. 30 T.C. at 1069.
56. 404 F.2d at 766.
57. 33 B.T.A. 928 (1936), appeal dismissed, 88 F.2d 1007 (10th Cir. 1937).
58. For a discussion of the origins of Treas. Reg. § 1.453-6(a)(1), see infra text accompanying notes 85-102.
59. 33 B.T.A. at 929-30. In other cases involving purchasers' obligations, but which did not directly address the § 1001 issue, courts have also regarded the taxpayer's accounting method as not determinative of the amount to be realized. See, e.g., Waukesha Malleable Iron Co. v. Commissioner, 67 F.2d 368 (7th Cir. 1933) (accrual basis seller allowed to defer receipt of option payment until option period ended); Woodmar Realty Co. v. Commissioner, 17 B.T.A. 88 (1929) (accrual basis taxpayer allowed to defer installment obligation with no fair market value).
market value rather than face value. In Revenue Ruling 79-292, however, the Service held that the regulation does not apply to accrual basis taxpayers. The Service cited Western Oaks Building Corp. v. Commissioner as the sole authority for its position. In Western Oaks the Tax Court relied on Spring City, First Savings & Loan, and Castner in finding that the accrual basis seller of real property must accrue the face amount of savings and loan shares. In footnote 4 of the Western Oaks decision, the court acknowledged the existence of section 1.453-6(a)(1) of the regulations, noted that the parties did not argue the regulation’s applicability, and stated that “[i]n any event, we interpret [section 1.453-6(a)(1) of the regulations] as being inapplicable to accrual method taxpayers.”

Western Oaks has been criticized on this point and several commentators take the position that the regulation’s fair market value limitation applies irrespective of the taxpayer’s accounting method. Curiously, the Castner opinion, cited in Western Oaks, indicated in dicta that the regulation applied to accrual basis sellers of real property.

It seems clear from the above analysis that the authority cited in Revenue Ruling 79-292 does not support the Service’s conclusion. The more far-reaching aspect of the ruling, however, is the Service’s assertion that “[t]here are no indications either in [section 1001] or in its legislative history that its application was intended to be limited to a particular type of sale.”

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In transactions included in paragraph (b)(2) of § 1.453-4, that is, sales of real property involving deferred payments in which the payments received during the year of the 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 in ascertaining the profit or loss from the transaction.

Id. at 167 (emphasis added).

61. 49 T.C. 365 (1968).

62. Id. at 372 n.4.

63. Ginsburg criticizes Western Oaks but fails to explain the basis of his disagreement. Ginsburg, supra note 22, at 557 n.259.


65. 30 T.C. at 1068. Also, Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766 (6th Cir. 1968), appears to take a similar position with regard to § 1.453-6(a)(1) of the regulations.

IV. THE RELATIONSHIP BETWEEN ACCOUNTING METHOD AND SECTION 1001

A. Section 1001's Legislative History

Section 1001(b)'s legislative history supports the conclusion that the section's fair market value language applies regardless of the taxpayer's accounting method. The following discussion will demonstrate that section 1001(b)'s present purpose is to measure the amount to be used in calculating a gain or loss after a realization event occurs. The Code does not explicitly define what constitutes a realization event; the parameters of realization have been developed by case law. When realization occurs, section 1001(b) operates as a measurement device. Sections 1001(b) and 451 operate independently; a taxpayer's method of accounting is irrelevant to section 1001(b)'s operation. Section 1001(b) can affect timing, but only in a tangential way: if an item is unmeasurable, or if an item is only to be measured to the extent of its fair market value, section 1001(b) will affect the timing of the recognition and cause a deferral.

The earliest version of section 1001(b) appeared as section 202(b) of the Revenue Act of 1918.67 Section 202(b) stated, "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain . . . be treated as the equivalent of cash to the amount of its fair market value, if any . . . ."68 Section 202(b) differed, however, from section 1001(b) in an important respect, as the following interpretive regulation illustrates:

Gain . . . 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.69

Section 202(b) thus described the circumstances under which the

67. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919) (current version codified at I.R.C. § 1001(b)).
68. Id.
taxing authority would find that income was to be realized.

In the Revenue Act of 1921, section 202(b) was amended and renumbered as section 202(c). The revised section read, "[f]or the purposes of this title, on an exchange of property . . . for any other . . . property, no gain . . . shall be recognized unless the property received in exchange has a readily realizable market value . . . ." The accompanying Senate Finance Committee report stated:

The existing [1918] law makes a presumption in favor of taxation. The proposed act [referring to section 202(c)] modifies that presumption by providing that in the case of an exchange of property for property no gain . . . shall be recognized unless the property received in exchange has a readily realizable market value . . . ."71

The section's emphasis shifted from realization to recognition; the modifying phrase "readily realizable" excluded certain receipts from taxation that presumably were taxable under the 1918 Act.72

Income realization and recognition were hotly debated issues in the early years of the federal income tax.73 A commentator in 1923 argued that the 1921 Act's "readily realizable" language was no more than Congress's attempt to force the Internal Revenue Service into a proper interpretation of section 202(b) under the 1918 Act.74 He argued that the use of the phrase "equivalent of cash" in section 202(b) was meant to include

property recognized as a medium of exchange. . . . It no doubt

70. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230 (current version codified at I.R.C. § 1001(b)).
71. S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921), reprinted in 95A Reams, supra note 44.
Gain or loss arising from the acquisition and subsequent disposition of property is realized only when as the result of a transaction between the owner and another person the property is converted into other property (a) that is essentially different from the property disposed of, and (b) that has a readily realizable market value. Property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property. In other words, the property received in exchange must be readily marketable at substantially its fair value in order that a gain or loss be recognized.
(emphasis added).
73. See generally Eisner v. Macomber, 252 U.S. 189 (1920) (stock dividend not income within the meaning of the sixteenth amendment).
includes United States Government bonds. It probably includes stocks and securities and commodities actively dealt in in large amounts. . . . It does not include much more. It does not include stock which my banker will not freely accept as collateral, for if such stock were the equivalent of cash, he would not hesitate. It does not include real estate which upon being put on the market may possibly be sold in a day, but just as possibly not for a month or longer. In short, it does not include property the possession of which would not be a sure protection against that kind of bankruptcy which sometimes happens to persons whose assets exceed their liabilities, but who are unable quickly to turn them into cash. If property is the equivalent of cash, it must be liquid and for all practical purposes as good as cash.\textsuperscript{7}

The Revenue Act of 1924 amended section 202(c), deleting the "readily realizable" market value language and substituting the present language of section 1001(b): "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."\textsuperscript{76} The report of the Senate Finance Committee expressly pointed out the changed purpose of section 202(c):

Subdivision (c) \textit{does not correspond to any provision of the existing law} but embodies in the law what is and has always been the construction of the law adopted by the department and by the courts; that is, that where income is \textit{realized} in the form of property the \textit{measure} of the income is the \textit{fair market value} of the property at the date of its receipt.\textsuperscript{77}

The House Report contains almost identical language.\textsuperscript{78} Congress,

\textsuperscript{75} Id. at 8.

\textsuperscript{76} Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 253, 256 (current version codified at \textit{I.R.C.} § 1001(b)).


\textsuperscript{78} H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924), \textit{reprinted in} 96 Reams, \textit{supra} note 44, states:

Subdivision (c) \textit{does not correspond to any provision of the existing law} but embodies in the law what is the correct construction of the existing law; that is, that where income is realized in the form of property, the measure of the income is the \textit{fair market value} of the property at the date of its receipt.

\ldots 

The existing law provides, in section 202(c), that no gain or loss is recognized (that is, considered for the purpose of determining taxable income) from an exchange of property unless the property received in exchange has a readily realizable market value.
in the 1924 Act, abandoned its earlier attempt to define a realization or recognition event and instead left this challenge to the Service and the courts. The congressional reports make it clear that section 202(c) of the 1924 Act measured the amount of gain, not whether a gain was realized or recognized. The use of money plus the fair market value of property as a measuring rule, while having no predecessor in the prior revenue acts, had nonetheless been consistently applied.

An analysis of the predecessors of section 1001(b) leads to several conclusions relevant to the question whether section 1001(b) operates without regard to a taxpayer’s accounting method. In the Revenue Acts of 1918 and 1921, Congress attempted to define when an income realization event occurred for noninventory sales.\(^7\) Such attempts to define realization of income by statute necessarily meant that Congress did not consider financial accounting rules for noninventory sales adequate to define when income should have been deemed realized for tax purposes. Consistent with this rejection of financial accounting rules for defining income realization, the 1918 and 1921 statutes combined a measurement rule with a realization rule, both independent of accounting methods. The 1924 statute, by abandoning a definition of realization, became a rule solely for measuring income, independent of a taxpayer’s accounting method.\(^8\)

**B. Section 1.453-6(a)(1) of the Regulations and Section 1001**

**1. INTRODUCTION**

Section 1.453-6(a)(1) of the regulations and its predecessors lend support to the thesis that section 1001 operates independently from a taxpayer’s method of accounting. Section 1.453-6(a)(1) of the regulations specifies that for deferred payments sales of real property which are not reported under the installment method, “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 in ascertaining the profit or loss from the trans-

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79. Section 1001(b) and its predecessors do not apply to inventory sales made in the ordinary course of business. See supra text accompanying notes 32-44. When the accrual method is necessitated by the keeping of inventories, the method itself defines when income is being realized.

80. See Goldberg, supra note 20, at 636.
The regulation makes no mention of a taxpayer's accounting method as affecting the regulation's operation and it appears to restate section 1001(b)'s language in the purchaser's obligation context.

The regulation has been used as authority for accrual basis sellers of realty to report the receipt of a purchaser's obligation at its fair market value. Revenue Ruling 79-292, however, rejected this argument. This controversy can be resolved by determining how section 1.453-6(a)(1) of the regulations and its predecessor regulations interpret section 1001(b) and its predecessor statutes when a seller receives an obligation of the purchaser. The answer to this question requires the resolution of several other issues: (1) Why is the regulation placed among the installment sales regulations; (2) Does the regulation only apply to a seller who cannot qualify for installment sale treatment or can a seller who qualifies, but does not elect to use section 453 (as in effect before the Installment Sales Act), rely on this regulation; (3) Can the regulation be applied to sales of personal property or is it limited to real property transactions, as it appears to be on its face; and (4) Does this regulation establish any additional authority for an accrual basis taxpayer to accrue obligations of a purchaser at fair market value, instead of face, if the regulation merely repeats the language of section 1001(b)? An understanding of the historical development of the installment regulations is a prerequisite to determining the force and scope of section 1.453-6(a)(1).

2. HISTORICAL DEVELOPMENT OF THE INSTALLMENT REGULATIONS

The Revenue Act of 1918 did not provide for the installment method of reporting because the Service had assured the legisla-

82. See George L. Castner Co. v. Commissioner, 30 T.C. 1061 (1958) (by implication); see also Jones Lumber Co. v. Commissioner, 404 F.2d 764 (6th Cir. 1968); 1 SURREY & WARRREN, supra note 32, at 868. Contra Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. 365 (1968); see also Desmond, supra note 22, at 41; Giljum, supra note 22, at 477.
84. Other commentators have raised, but left unanswered, the same issues. D. HERWITZ, supra note 32, at 491-97; Giljum, supra note 22, at 477. Another commentator attempted to answer these questions, but was, in this author's opinion, unsuccessful. See Haley, supra note 15, at 318-21.
85. Revenue Act of 1918, ch. 18, § 212(b), 40 Stat. 1057, 1064-65 (1919), states:

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if
tive committees that section 212(b) authorized the Service to issue the appropriate regulations. Articles 42 through 46 of Regulation 45, promulgated by the Treasury Department under section 213(a) of the 1918 Act, comprised the first comprehensive attempt to provide for an installment method of reporting. Article 42 applied only to personal property sales, while articles 43 through 46 applied to real property sales.

Article 44 defined when deferred payment sales of realty qualified for installment sales treatment and article 45 provided the rules of reporting when the taxpayer qualified for installment treatment under article 44. Additionally, article 45 permitted tax-

the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

86. Doyle, Taxation of Income Derived from Installment Sales, 4 Taxes 53, 54-56 (1926).
88. Revenue Act of 1918, ch. 18, § 213(a), 40 Stat. 1057, 1065 (1919), reads:

That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property . . . . The amount of all such items shall be included in the gross income for the taxable year in which received . . . unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period . . . .

89. Treas. Reg. 33, art. 117, T.D. 2690, 20 Treas. Dec. Int. Rev. 126, 187 (1918), reprinted in 132 Reams, supra note 44, constituted the Treasury’s previous attempt to provide for installment reporting. The Treasury issued the regulation in January 1918, but because it was incomplete, it received little use. Doyle, supra note 86, at 53-54.

Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount . . . .

(2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

91. Treas. Reg. 45, art. 45, T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 185-86 (1919), reprinted in 134 Reams, supra note 44, provided in part: “[T]he vendor may report as his income from [installment] transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.”
payers who qualified for the installment method to, in essence, elect not to report under the installment method. Article 46 thus applied both for taxpayers who elected out and in situations where the sale of real estate did not qualify for installment treatment. Article 46 specified how a taxpayer would measure his gain upon the receipt of a purchaser's obligation from the sale of real estate: "These obligations for deferred payments are therefore to be regarded as equivalent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed." This regulation was an interpretation of section 202(b) of the 1918 Revenue Act, and was not a separate rule formulated by the Treasury Department to govern the reporting of gain from the receipt of purchaser obligations.

The link between the regulation and the Code section is indicated by the fact that as Congress subsequently amended section 202(b), the language of article 46 underwent similar modifications. Following the 1921 Act, the Treasury added section 202(c)'s "readily realizable market value" language to article 46. In 1927,

92. Article 45 provided:

If the taxpayer chooses as a matter of settled practice consistently followed to treat the obligations of the purchaser as equivalent to cash and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in article 46 will apply.


93. Treas. Reg. 45, art. 46, T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 186 (1919), reprinted in 134 Reams, supra note 44 (emphasis added). The italicized phrases seem to require that the full face amount of the purchaser's obligation be included in income in the year of sale. Haley so concluded, using the rationale that the obligations are worth their face value because of the substantial down payment. Haley, supra note 15, at 319-20. Although Haley correctly recognized that article 45 applied § 202(b) of the Revenue Act of 1918 to the receipt of purchaser's obligations, he did not stress that article 46's "equivalent to cash" language provided a shortened version of § 202(b)'s realization rule: "[P]roperty received in exchange shall . . . be treated as the equivalent of cash to the amount of its fair market value, if any . . . ." Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919) (emphasis added). The important point is that article 46, because it applied § 202(b), did not require that the face amount of a purchaser's obligation be recognized in the year of the sale; rather, the obligations were only recognized to the extent of their fair market values.

94. As discussed earlier, § 202(b) of the Revenue Act of 1918 was a predecessor to § 1001(b). See supra text accompanying notes 67-80. Article 46 was not a separate rule formulated by the Service; rather, it was derived from § 202(b).

95. Section 202(b) was republished as § 202(c) in the 1921 Act. See supra text accompanying note 70.

96. Treas. Reg. 62, art. 46, T.D. 3295, 24 Treas. Dec. Int. Rev. 207, 228 (1922), reprinted in 136 Reams, supra note 44, provided in part: "If these obligations [of the pur-
following a change in section 202(c)'s language, the Treasury replaced article 46's "readily realizable market value" words with "fair market value." In 1926 article 46 was again amended to conform better to section 202(c)'s language. Section 1.453-6(a)(1) of the regulations succeeded article 46 and replaced the "equivalent to cash" language of the 1926 version with the current "amount realized" wording. Clearly, section 1.453-6(a)(1) of the regulations and its predecessors have followed the changing language of section 1001(b) and its predecessor statutes; section 1.453-6(a)(1) of the regulations simply interprets section 1001(b) when a seller receives a purchaser's obligation.

The reason for placing regulation 1.453-6(a)(1) within the installment sales regulations can best be explained through an examination of its historical development. In the Revenue Act of 1926, Congress first added a separate statutory provision, section 212(d), for installment reporting. Articles 42 and 44 were amended to make specific reference to section 212(d). This later codification of the installment method and the retention of the major portion of section 202(c)'s installment regulations, articles 42 through 46, explains mechanically why section 1.453-6(a)(1) of the regulations appears among the installment regulations rather than grouped together.

[References]

97. Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 253, 256 (current version codified at I.R.C. § 1001(b)).

98. Treas. Reg. 65, art. 46, T.D. 3640, 26 Treas. Dec. Int. Rev. 745, 746 (1924), reprinted in 137 Reams, supra note 44, provided in part: "If these obligations [of the purchaser] have a readily realizable market value . . . they are to be considered as the equivalent of cash and the profit realized from the transaction is taxable income for the year in which the initial payment was made and the obligation assumed." (emphasis added).

under section 1001.

In determining whether section 1.453-6(a)(1) only applies to a seller who fails to qualify for installment sale treatment, the above historical discussion is applicable. Article 46, the predecessor to section 1.453-6(a)(1), explicitly controlled situations in which sellers elected not to use the installment reporting method. Section 1001(b) applies to sales in which the seller qualifies for installment reporting but elects not to use that method. This statute does not distinguish between those situations in which a taxpayer qualifies for, but elects out of the installment method, and those in which he fails to qualify for its use under the rules applicable before the Installment Sales Revision Act of 1980. For these reasons, section 1.453-6(a)(1) clearly also applied to sellers who qualified for installment sale treatment but did not elect to use section 453.

If section 1.453-6(a)(1) of the regulations merely applies section 1001(b) to the receipt of a purchaser's obligations, then the regulation should be applicable to casual sales of personal property because section 1001(b) makes no distinction between casual sales of personal property and sales of real property. The absence of a regulation similar to section 1.453-6(a)(1) dealing with casual sales of personal property can be attributed to the installment regulations' development by a process of amendment. The regulations issued under the Revenue Act of 1918 did not contain a separate article for personal property sales not qualifying for installment method reporting, as did article 46 for real property sales. This omission explains the absence of a comparable regulation in the later regulations as amended. The absence of a separate regulation probably resulted from the 1918 regulation's emphasis on personal property sales by dealers and the lack of a distinction between casual sales and sales by a dealer.

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103. See supra text accompanying notes 85-100.
104. For the relevant language of article 46, see supra text accompanying note 93.
105. The Installment Sales Act renders this issue practically moot; today there are very few situations in which a seller of real property would not qualify for the installment sales method.
107. One of the primary objectives of the 1918 installment regulations was to provide relief for dealers in personal property. See Doyle, supra note 86, at 53-54. Personal property sales by dealers in the ordinary course of business are subject to normal accrual rules and not § 1001. The concept of casual sales of personal property did not become an express part of the installment method of reporting until the codification of the installment method in the Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 9, 23 (current version codified at I.R.C. §
The final and most important question is whether regulation 1.453-6(a)(1) establishes any additional authority for an accrual basis taxpayer to accrue obligations of a purchaser at fair market value rather than at face value. Section 1.453-6(a)(1) of the regulations merely repeats the language of section 1001(b), so one can argue that the regulation itself is not an authoritative source to answer the question whether the fair market value rule of section 1001(b) applies to accrual basis taxpayers. An independent authoritative interpretation of section 1.453-6(a)(1)'s predecessors does exist, however, in the Service's early explanations of article 46.

A 1930 I.R.S. training manual on installment sales explained how to report gains from deferred payment sales not on the installment plan pursuant to article 46 of the 1926 and 1928 Revenue Acts. The manual presented an illustrative problem involving a deferred payment sale by a real estate dealer whose "books are kept on the accrual bases," and stated that the seller's gain is measured by "cash received plus the amount of the first mortgage (assumed by the purchaser) plus the fair market value of the second mortgage . . . ." The manual further explained:

Assuming a case, where the property is not encumbered by any mortgages, and the purchaser gives a first and second mortgage, the seller, in reporting profit in the year of sale, is privileged to value the first trust as well as the second trust at their current fair market values. Rarely, if ever, would the first mortgages in such instances have a value less than face value.

There are at least two reasons why the Treasury explicitly made the fair market value rule applicable to real estate sales but gave no indication as to the applicability of the rule to casual sales of personal property. First, there was no regulation for casual sales of personal property similar to article 46 for real property sales. Second, it appears that during the 1920's, the real estate industry strongly lobbied for legislation permitting the reporting of deferred payment sales of realty by the open transaction or cost recovery

453).

108. U.S. TREASURY DEP’T BUREAU OF INTERNAL REVENUE, INSTALLMENT SALES UNDER THE REVENUE ACTS OF 1926 AND 1928 (1930), reprinted in 126 Reams, supra note 44. Chapter five of this confidential training manual, beginning on page 34, discussed reporting requirements for deferred payment sales not on the installment plan.

109. Id. at 35-36 (emphasis added).

110. Id. at 36 (emphasis added).

111. Id.

112. See supra notes 106-07.
method.\textsuperscript{113} Although the industry lost the battle for such legislation,\textsuperscript{114} the lobbying effort resulted in a decision that accrual basis sellers of realty could report purchasers’ obligations at fair market value.\textsuperscript{115}

V. REVENUE RULING 79-292 AND DEFERRED REPORTING

A. Introduction

In Revenue Ruling 79-292, the Service takes theoretically inconsistent positions with regard to income deferrals arising from purchasers’ obligations. The ruling asserts that for sales by accrual basis taxpayers within the scope of section 1001(b), the taxpayer’s accounting method must be taken into account in determining the amount realized. This position denies the taxpayer the opportunity to defer the difference between the obligation’s face and fair market values.\textsuperscript{116} Concurrently, the Service denies open transaction deferral to a cash basis taxpayer in a situation in which the pur-

\textsuperscript{113} See H.R. Rep. No. 2, 70th Cong., 1st Sess. 15-16 (1927), reprinted in 98 Reams, supra note 44; H.R. Doc. No. 139, 70th Cong., 1st Sess. 12-13 (1928) (letter from the Chairman of the Joint Committee on Internal Revenue Taxation), reprinted in 98 Reams, supra note 44; see also Hearings on Revenue Revision, 1927-1928, Before the House Comm. on Ways and Means, Interim, 69th Cong.-70th Cong. 456 (1927) (amendment to the Revenue Act of 1926 proposed by the Florida Institute of Accountants) [hereinafter cited as Florida Accountants], reprinted in 8 Reams, supra note 44; Hearings on Revenue Revision, 1925, Before the House Comm. on Ways and Means, 69th Cong., 1st Sess. 152 (1925) (statement of Dr. Joseph J. Klein) [hereinafter cited as Klein], reprinted in 7 Reams, supra note 44; Pinkerton, Deferred Payment Sales of Real Estate, 5 Taxes 47, 49-50 (1927).

\textsuperscript{114} See H.R. Rep. No. 2, 70th Cong., 1st Sess. 15-16 (1927), reprinted in Reams, supra note 44.

\textsuperscript{115} The motivation for the real estate industry’s strong lobbying efforts in the 1920’s can be understood by reference to business and accounting practices during that period. During boom times, such as those that existed in Florida and California during the 1920’s, speculative land developers would usually sell undeveloped real estate by contract. See D. Herwitz, MATERIALS ON ACCOUNTING FOR LAWYERS 306 (1976); Klein, supra note 113, at 152; see also Florida Accountants, supra note 113, at 456-58; Pinkerton, supra note 113, at 49. Accepted accounting rules allowed the face amount of the obligation to be accrued as income even though many of the obligations later proved uncollectible. See Klein, supra note 113, at 153. There was, therefore, great incentive for a real estate dealer to keep his books on the accrual basis. He could present an overstated income statement to potential investors, but for tax purposes only report the fair market value of the purchaser’s obligation. This technique would produce a partial deferral when the initial payment was too large to qualify for installment reporting or when a taxpayer elected not to use the installment method. The onset of the Great Depression and the end of the real estate boom, however, may have caused a significant decline in the use of this method for reporting gains from deferred payment sales. The decline in the use of this method may at least partially explain the subsequent confusion over the applicability of article 46, and later § 1001(b), to accrual taxpayers.

\textsuperscript{116} See supra text accompanying note 18.
chaser’s obligation is not a cash equivalent. Instead of allowing a taxpayer to report gain in accordance with his accounting method, the Service forces him to realize the fair market value of the obligation.\textsuperscript{117}

The theoretical difficulty with the Service’s respective treatment of cash basis and accrual basis taxpayers arises from the Service’s inconsistency. The Service denies the cash basis taxpayer the use of his accounting method in deferring income under section 1001(b), but the Service requires the accrual basis taxpayer to report income in accordance with his accounting method. As previously demonstrated,\textsuperscript{118} the historical development of section 1001 and its interpretive regulations indicate that the sounder interpretation is that section 1001(b) operates independently of a taxpayer’s accounting method.

B. The Cash Equivalency Doctrine

The cash equivalency doctrine, in its broadest sense, allows a cash basis taxpayer to exclude from income the value of any property which cannot be readily converted into money.\textsuperscript{119} This doctrine only applies to cash basis taxpayers; it should not operate for sales transactions which fall within the scope of section 1001(b) because the fair market value limitation of this section operates independently of a taxpayer’s accounting method. Thus, when applying the cash equivalency doctrine, it is essential to distinguish between transactions governed by section 1001 and those which are not. The courts have correctly applied the cash equivalency doctrine in non-sale\textsuperscript{120} situations, but have erroneously applied the doctrine in sale\textsuperscript{121} situations.\textsuperscript{122} The Service, however, has correctly


\textsuperscript{118} See supra text accompanying notes 67-80, 85-100.

\textsuperscript{119} See Goldberg, supra note 20.

\textsuperscript{120} Transactions outside the scope of § 1001(b) are hereinafter referred to as “non-sale” situations, and include sales of personal property in the ordinary course of business as well as situations in which the taxpayer receives compensation for personal services or rent or royalty income.

\textsuperscript{121} Transactions within the scope of § 1001(b) are hereinafter referred to as “sale” situations, and include all sales of real property and casual sales of personal property. For an analysis of the scope of section 1001(b), see supra text accompanying notes 32-44.

\textsuperscript{122} Compare Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961) (promise of future royalty payments under an oil and gas lease may be equivalent to cash if obligor is solvent and the promise is assignable, unconditional, not subject to set-offs, and not discounted at a rate “substantially greater” than the prevailing market rate) with Ennis v.
recognized that the doctrine should only apply in non-sale situations,122 as opposed to a sales context where section 1001(b) operates independently of a taxpayer’s accounting method.124

In determining whether a purchaser’s obligation is a cash equivalent, the courts have applied a marketability standard.125 One test of marketability used by the courts is whether the purchaser’s obligation can be transferred at a discount not substantially greater than the prevailing premium for the use of money.126 The Service, however, does not support this deep discount test, as evidenced by its position in Warren Jones Co. v. Commissioner.127

C. Warren Jones Co. v. Commissioner

In Warren Jones, the Tax Court held that a cash basis seller’s receipt of a real estate contract with a face value substantially greater than its fair market value was not the equivalent of cash because of the deep discount necessary to convert it into cash. Accordingly, the Tax Court held that the taxpayer should not treat the contract as an amount realized from the sale. The Court of Appeals for the Ninth Circuit reversed and held that under section 1001, the taxpayer realized the fair market value of the contract.128 The court stated that it was unclear whether the Commissioner argued for a rejection of the deep discount test of cash equivalency, or, more broadly, that the fair market value language of section 1001(b) operated independently of a taxpayer’s accounting method.129 Because both arguments produced the same result for a cash basis taxpayer, the court stated that it did not have to choose between the two theories.130

In Warren Jones the Commissioner advanced the argument that the fair market value rule of section 1001(b) took precedence over a taxpayer’s accounting method, but did not make any con-
cessions that would undermine a similar application to accrual basis taxpayers. The Ninth Circuit devoted the bulk of its opinion to an analysis of the legislative history of section 1001(b), although it also made an attempt to reconcile its result with Cowden v. Commissioner. At issue in Cowden was the receipt of advance royalty payments in the form of a deferred payment agreement related to an oil and gas lease. The Commissioner, the Tax Court, and the United States Court of Appeals for the Fifth Circuit determined that the contractual obligation to make payments in future years represented ordinary income subject to depletion; Cowden was thus a non-sale case. The Fifth Circuit stated that one condition to finding that a purchaser's obligation is the equivalent of cash is whether the holder of the obligation could transfer it "at a discount not substantially greater than the generally prevailing premium for the use of money . . . ." The Fifth Circuit thus established a "deep discount" test for cash equivalency.

The Warren Jones court stated that its decision did not conflict with Cowden because the deep discount language used in Cowden was merely "a description of the obligation involved in that case" and was not meant to be a test of cash equivalency. The court of appeals was forced to adopt this strained interpretation of Cowden because it failed to recognize that Cowden was a non-sale case, distinguishable on the basis of the inapplicability of section 1001(b). The court’s analysis of the legislative history of section 1001(b) and its failure to recognize the section’s inapplicability in Cowden strongly indicate that the court did not reject the deep discount test of the cash equivalency doctrine and that the thrust of the Commissioner’s argument was not directed toward this narrow issue.

Thus, the Service takes inconsistent positions in Revenue Ruling 79-292 and Warren Jones. In Revenue Ruling 79-292, the Service seeks to tax accrual basis sellers on the basis of their accounting method, irrespective of section 1001(b)’s fair market value language. But based on the holding in Warren Jones, the Service also seeks to tax cash basis sellers under the language of section 131.
1001(b), notwithstanding their method of accounting.

As previously demonstrated, the legislative history of section 1001(b) indicates that the Warren Jones holding is correct. Note that Revenue Ruling 79-292 did not discuss the legislative history of section 1001(b), but the court in Warren Jones did.

The Warren Jones court traced the development of section 1001(b) from its inception in section 202(b) of the Revenue Act of 1918, through section 202(c) of the Revenue Act of 1921, and into the pertinent parts of section 202(c) of the Revenue Act of 1924, which contained the present statutory language. The court equated the "readily realizable market value" test of the 1921 Act with the taxpayer's argument that the contract was not a cash equivalent because of the deep discount. The court stated that Congress's replacement of the "readily realizable market value" test with the fair market value language of the 1924 Act evidenced its intent "to establish the more definite rule for which the Commissioner here contends and that consequently, if the fair market value of property received in an exchange can be ascertained, that fair market value must be reported as an amount realized." The Ninth Circuit noted that such an interpretation could work substantial hardship on a taxpayer by forcing him to sell the purchaser's obligation in order to pay the tax imposed on the sale and, more importantly, because the transaction was closed, the taxpayer would only enjoy capital gain treatment to the extent that the fair market value of the purchaser's obligation plus any cash received exceeded his basis. Any amounts he collected in excess of the obligation's fair market value would be taxable as ordinary income.

The court reasoned that the installment method of reporting gains under section 453 was "Congress's method of providing relief from

135. See supra text accompanying notes 67-80.

136. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919), provided in part: "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any . . . ."

137. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230 provided in part: "For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value . . . ."

138. Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 253, 256 provided in part: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

139. 524 F.2d at 792.

140. Id.
the rigors of section 1001(b)."141

The court did not, however, extend its analysis of section 1001(b) to determine whether its legislative history supported a literal reading of the fair market value rule with respect to accrual basis taxpayers. Because the court was not compelled to decide whether a taxpayer's accounting method was subordinate to the rule prescribed by section 1001(b), it produced an incomplete analysis of the legislative development of this section and its predecessor statutes. Nonetheless, the court's holding that the fair market value language of section 1001(b) operates independently of a cash basis taxpayer's accounting method should be applied also to accrual basis taxpayers.

D. Temporary Regulation Section 15A.453-1(d)(2)

In the temporary regulations under the Installment Sales Act,142 the Service asserts an internally inconsistent position. Section 15A.453-1(d)(2)(i) of the temporary regulations first states that "a taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting."143 The regulation adds, however, that the receipt of an installment obligation must be treated as a receipt of property in an amount equal to the fair market value of the obligation, "whether or not such obligation is the equivalent of cash."144 Section 15A.453-1(d)(2)(ii)(A) of the temporary regulations states that "[u]nder no circumstances will an installment sale for a fixed amount obligation be considered an 'open' transaction."145 The regulation then states that a cash basis taxpayer must realize the fair market value of the obligation while an accrual taxpayer must realize the face amount of the obligation in the year of sale.146

The temporary regulations clearly adopt the position in Revenue Ruling 79-292 that a taxpayer's accounting method supersedes the language of section 1001(b). The temporary regulations, however, just as clearly reject the applicability of the cash equivalency doctrine to sales. These positions are contradictory in light of the Service's and the courts' acceptance of cash equivalency as a valid

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141. Id.
144. Id.
146. Id.
attribute of the cash method of accounting.147

Neither section 453, added by the Installment Sales Act, 148 nor the accompanying Senate Finance Committee Report149 gives any indication that Congress intended to change the relationship between section 1001(b) and a taxpayer’s method of accounting. The committee report does not state how accrual basis taxpayers, who elect out of section 453, are to report gains from sales involving receipt of a purchaser’s obligation. The report contains, however, what appears to be a rejection of the cash equivalency doctrine as applied to sales. It first states that open transaction treatment should be even more limited under the Installment Sales Act because installment reporting now applies to sales involving contingent selling prices.150 The report concludes that open transaction treatment should be limited to Burnet v. Logan situations,151 and that “it is the Committee’s intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller’s [sic] [buyer’s] obligation is evidenced by a note, contractual promise, or otherwise) . . .”152 The parenthetical clause appears to be aimed at the cash equivalency doctrine. The proper conclusions to be drawn from the Installment Sales Act and the Senate Finance Committee Report are simply that Congress did not address directly the section 1001(b) issue, unless one can interpret the Senate Finance Committee’s apparent rejection of cash equivalency in sales situations as evidence that the fair market rule of section 1001(b) supersedes a taxpayer’s accounting method.153

In temporary regulation 15A.453-1(d)(2)(ii), the Service attempts to obtain the best of both possible worlds: it denies defer-

147. See Rev. Rul. 68-606, 1968-2 C.B. 42; see also Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961); Schlemmer v. United States, 94 F.2d 77 (2d Cir. 1938); Kniffen v. Commissioner, 29 T.C. 553 (1958); Williams v. Commissioner, 28 T.C. 1000 (1957).
150. S. REP. No. 1000, supra note 149, at 24. Prior to the Installment Sales Act, the courts had held that the selling price had to be fixed and determinable to qualify the sale for installment reporting under § 453(b). See, e.g., Gralapp v. United States, 458 F.2d 1158 (10th Cir. 1972).
151. See supra notes 19-22 and accompanying text.
152. See S. REP. No. 1000, supra note 149, at 24.
153. The committee likely did not have a firm grasp of the relationship among deferred reporting, cash equivalency, § 1001(b), and a taxpayer’s accounting method. The committee report contains a misstatement of the law with its apparent limitation of the applicability of the Burnet v. Logan open transaction treatment to cash basis taxpayers. S. REP. No. 1000, supra note 149, at 23.
rals for accrual basis taxpayers because the operation of section 1001(b) depends upon a taxpayer’s accounting method, and it denies deferrals for cash basis taxpayers because section 1001(b) operates independently of a taxpayer’s accounting method. The Service may justify its position as an attempt to induce both accrual basis taxpayers and cash basis taxpayers to report under the installment method and thereby report consistently. But to the extent that a taxpayer elects out of the installment method, the regulations present an internally inconsistent position.

Given the legislative history of section 1001(b) and the Service’s position in Warren Jones, the Service should recognize that the fair market value language of section 1001(b) operates irrespective of a taxpayer’s accounting method. In the alternative, if the Service maintains the position in Revenue Ruling 79-292 that accounting method controls the amount realized under section 1001(b), then it should allow a cash basis taxpayer to use the deferral provided by the cash equivalency doctrine. 1

VI. CONCLUSION

The holding in Revenue Ruling 79-292 that accrual basis taxpayers must report the face amount of a purchaser’s obligation under section 1001(b) receives only minimal support from the authorities it cites. Additionally, the holding does not comport with either Congress’s intent to have section 1001(b) operate independently of the taxpayer’s method of accounting. This intent is evidenced by the legislative development of section 1001(b) and the application of section 1001(b)’s original regulations to the receipt of a purchaser’s obligation as initially interpreted by the Service.

The temporary regulations under the Installment Sales Act adopt reporting rules for cash and accrual basis taxpayers that result in inconsistent applications of section 1001(b). Congress did not, however, directly address the section 1001(b) issue in the Act. Although the Senate Finance Committee Report does contain a statement that appears to prohibit the use of the cash equivalency doctrine, neither the Installment Sales Act itself, nor the accompanying committee report contains any language which provides a basis for the temporary regulation’s requirement that accrual taxpayers accrue the face amount of a purchaser’s obligation.

If Revenue Ruling 79-292 and the accrual rule adopted in the temporary regulations do correctly interpret section 1001(b), then

154. See Goldberg, supra note 20.
cash method taxpayers have a strong argument that the cash equivalency doctrine applies to sales under section 1001(b), contrary to the result in Warren Jones, the Senate Finance Committee Report, and the cash method rule in Temporary Regulation section 15A.453-1(d)(2)(i).