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Will Refinancing an Installment Sale Obligation Trigger Recognition of Gain?

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WILL REFINANCING AN INSTALLMENT SALE OBLIGATION TRIGGER RECOGNITION OF GAIN?

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A discussion of the refinancing of installment obligations and whether such refinancing will trigger recognition of gain.

Introduction

With the recent decrease in interest rates, many real estate owners are taking the opportunity to improve their financial position by refinancing existing mortgages at the new lower rates. This most recent movement to restructure debt raises an interesting tax question: Will the refinancing of an existing installment sale debt instrument at a lower interest rate, either by changing the terms of the original instrument or by substituting a new debt instrument in place of the original, trigger immediate recognition of the balance of the previously deferred gain for income tax purposes?

For example, in 1993, Linda Johnson sold a ten unit apartment building with a tax basis of $500,000 to Ken Kida for $1 million, realizing a long term capital gain of $500,000. However, by taking back an $800,000 first mortgage with a 10 percent interest rate, Johnson was able to defer recognition of 80 percent or $400,000 of her $500,000 realized gain. [FN1] In 1996, because interest rates have dropped to 7 percent, Kida has asked Johnson to change the terms of the $800,000 first mortgage (i.e., reducing the interest rate to 7 percent). Kida has informed Johnson that, if Johnson does not reduce the interest rate, he will pay the one percentage point prepayment penalty and refinance with Bank of Deals at 7 percent.

Johnson definitely does not want Kida to payoff his installment note because if he did, she would have to recognize the remaining balance of her deferred installment sale gain. [FN2] An economic reason to defer the gain *288 is that currently there are proposed tax law changes being discussed by Congress that could significantly reduce any income tax on future capital gains, or even eliminate the capital gains tax altogether. Therefore, Johnson is willing to change the terms of the existing mortgage to a 7 percent interest rate for a one percentage point fee if the modification will not have any other adverse tax or economic effects. Kida is willing to accept these new terms because this would put him in exactly the same place he would have been in if he had refinanced with Bank of Deals.

Johnson, therefore, wants to know: Would these proposed changes to the installment mortgage be deemed a disposition that would trigger recognition of the balance of her deferred long term capital gain?

Tax Consequences of a Disposition of an Installment Obligation

It is clear that when a sale is reported using the installment method of accounting and the seller disposes of the installment obligation, the amount that the seller realizes is treated as though the seller collected on the obligation.[FN3] Furthermore, if the asset originally sold was a capital asset, then gain or loss on the disposition of the installment obligation is a capital gain or loss. [FN4] The holding period for the gain recognized includes only the period during which the original asset was held, not including the time the installment obligation was held.

If an installment obligation is sold or exchanged or if it is satisfied for an amount other than face value, the gain or loss realized is the difference between the amount realized by the holder of the obligation and the basis of the obligation. [FN5] Basis is the excess of the face amount of the obligation over the income the seller would have recognized if the obligation had been paid in full. [FN6]

For example, assuming no reduction of principal, Johnson's basis in her installment obligation is $400,000 [(face value of obligation = $800,000)- (deferred gain = $400,000)]. Therefore, if Kida satisfies Johnson's installment obligation for $808,000 ($800,000 face value plus one percent prepayment fee), Johnson will recognize a capital gain of $408,000 at the time of the installment sale disposition.

Dispositions, other than by sale or exchange, can trigger gain on an installment obligation. For instance, if an installment obligation is transferred as a gift or in trust or is disposed of in any other way except by sale or exchange, death, or certain transfers to spouses, the gain or loss is *289 the difference between the fair market value of the installment obligation at the time of the disposition and its basis, determined as described above. [FN7]

In cases where the installment obligation is transferred at death, the estate or beneficiaries report the income in the same way it would have been reported if the decedent had survived. [FN8] Similarly, gain or loss is generally not recognized when installment obligations are transferred between spouses during marriage or between former spouses incident to divorce. [FN9] It is important to note, however, that when installment obligations are transferred in trust between spouses during marriage or incident to divorce, gain or loss will be recognized from the transfer. [FN10]

With respect to Johnson's situation, if an installment obligation is cancelled, becomes unenforceable, or is materially altered, it will be treated as a disposition of an installment obligation that does not constitute a sale or exchange. [FN11] Consequently, if it is determined that the modification of terms requested by Kida materially alters Johnson's installment obligation, she will realize gain measured by the difference between fair market value of the installment obligation and the basis of the obligation, or $408,000. Therefore, it is critical to examine what types of modifications are considered to "materially alter" an installment obligation.

Material Alteration of an Installment Obligation

Generally, a disposition of an installment obligation under Section 453B occurs when the seller's rights either disappear or are materially disposed of or are altered such that the need for postponing recognition of the previously realized gain disappears.

For example, in Revenue Ruling 82-188, [FN12] a disposition occurred when the obligor (a corporation) substantially increased the face amount of the outstanding obligation in consideration for the seller/taxpayer's waiver of his right to convert the obligation into shares of common stock of the obligor. The Service concluded that the substantial increase in the face value of the note was a material change in the taxpayer's rights resulting in a taxable disposition of the original installment obligation. In a similar revenue ruling, [FN13] a bondholder's waiver of an otherwise automatic *290 interest rate adjustment clause was also considered a material change resulting in a taxable disposition.

Before the Supreme Court's decision in Cottage Savings [FN14] it was clear that most modifications or changes to installment obligations did not constitute taxable dispositions. For example, modifying an installment obligation to raise the interest rate from 6 percent to 7 percent and deferring the payment dates by five years did not result in a deemed disposition of the installment obligation. [FN15] Similarly, the Service found in a private letter ruling that reissuance of a bond with a new interest rate, along with a temporary deferral of the principal payments and the addition of a prepayment penalty was not a taxable disposition of the installment obligation. [FN16] Also, in Revenue Ruling 74-157, [FN17] the substitution of two promissory notes on two parcels of land for a single note secured by one parcel of land covering the same acreage and total dollar amount, did not constitute a taxable disposition of the installment obligation. Similarly, the Service, in another revenue ruling, held that the substitution of a mortgage contract in place of a land contract with the same terms and conditions was merely a substitution of security and not a taxable disposition of an installment obligation. [FN18]

Based on these precedents, it would appear that Johnson should not have to recognize the balance of her deferred installment gain if she agrees to change the terms of the installment debt instrument in order to accommodate Kida's demands. However, the ambiguity caused by Cottage Savings and the subsequent proposed and final regulations to Section 1001 have raised critical questions concerning the current status of what changes to an installment debt instrument will trigger a disposition under Section 453B.

Ambiguity Created by Cottage Savings Association v. Comm'r

Regardless of the precedents cited above, the Supreme Court's decision in Cottage Savings has led to some controversy concerning modification of debt instruments. In Cottage Savings the taxpayer engaged in a series of purchases and sales of mortgage participation interests. In each transaction, Cottage Savings sold mortgage participation interests to another financial institution and purchased substantially identical mortgage participation interests from that same financial institution. These *291 exchange transactions were recorded as sales and purchases of the mortgage participation interests.

Cottage Savings treated the transactions as realization and recognition events under Section 1001 and claimed the losses on its tax returns. The Service contended that the losses should be disallowed because the exchanged properties were economically equivalent and, therefore, did not differ materially within the meaning of the underlying regulations. [FN19] The Court held, however, that Cottage Savings had realized a loss because the participation interests exchanged were derived from loans made to different obligors and were secured by different homes. Therefore, the exchanged interests embodied legally distinct entitlements and thus, were materially different, resulting in a sale or disposition under Section 1001. In response to the ambiguity created by Cottage Savings and to provide some certainty in this area, in December 1992, Treasury issued proposed regulations under Section 1001 to deal explicitly with the modification of debt instruments. [FN20] These regulations were published as final regulations in the Federal Register in a somewhat modified form on June 26, 1996. [FN21]

Even though Cottage Savings did not involve modification of an installment obligation, it has raised questions about the Supreme Court's interpretation of the "material difference standard" and the possible application of the Cottage Savings standard to modifications of installment sale obligations. It is not clear to what extent the regulations at Section 1.1001-3 should control the treatment of transactions under Code sections other than Section 1001.

Treasury has expressly recognized this concern. The preamble to the Proposed Regulations under Section 1001 sets forth that the determination that there is a sale or disposition under Section 1001 does not "conclusively" determine that there has been a disposition of an installment sale obligation under Section 453B.
Perhaps with more certainty, the preamble to the Final Regulations states that "a modification of a debt instrument that results in an exchange under section 1001 does not determine if there has been an

exchange or other disposition of an installment obligation under section 453B. Whether or not there has been an exchange or other disposition of an installment obligation is determined under the cases and rulings applicable to section 453B." Thus, while the Regulations under Section 1001 do not determine if an exchange has occurred with respect *292 to an installment sale obligation, to what extent they are relevant in the determination process is the unanswered question.

Regulations Section 1.1001-3: The Modification of Debt Instruments

One reason that the Court's holding in Cottage Savings is disconcerting to holders of installment obligations is because the language used in the general rule in the Regulations, which states that it is expressly for purposes of clarification in the Regulations under Section 1.1001-1(a), "[a] modification that is not a significant modification is not an exchange ...," [FN22] is similar to the language used by Treasury in its rulings concerning the meaning of a disposition under Section 453B, that is:

...a significant modification of a debt instrument ... is deemed to result in an exchange ...

Additionally, these terms are not defined in Section 453B, but are expressly defined in the Regulations under Section 1001. The Regulations define the term "modification" and provide intricate and detailed rules for determining when a modification is significant. [FN23] Examples illustrating the application of the rules are also provided in the Regulations. [FN24]

Therefore, because of the absence of definitions and specificity under Section 453B, it may be prudent when considering whether changes to an installment debt instrument are deemed a disposition to consider what the determination would be if the Service or the courts were to apply the standards under the 1001-3 regulations. In any event, under both Sections 1001 and 453B, a disposition will only occur if there is a significant modification.

Perhaps most importantly, Regulations Section 1.1001-3 provides that the definition of "modification" is inclusive of any alteration, "whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise," [FN25] unless specifically excepted. The exceptions are as follows:

1. Alterations occurring by operation of the terms of a debt instrument unless the alteration is a change in obligor or nature of the instrument; an alteration that results in an instrument or property right that is not debt for federal income tax purposes; or certain alterations resulting from the exercise of a unilateral option. [FN26]

2. Failure to perform [FN27] Very clearly, "the failure of an issuer to perform its obligations under a debt instrument ...is not a modification." Even further, "an agreement by the holder to temporarily stay collection or temporarily waive an acceleration clause or similar default right ... is not a modification.

3. Failure to exercise an option. [FN28] If a party to the instrument does not exercise an option to change one of its terms, this failure is not a modification.

Because Johnson's proposed changes to the installment sale debt instrument do not fall under these exceptions, it would appear that both the lowering of the interest rate and the acceptance of the fee for doing so would constitute a modification under the stricter standards of the 1001-3 Regulations. A modification must be significant, however, for a disposition to be deemed to have occurred under these regulations.

Specific rules are provided in the Regulations that must be applied to determine whether a modification of a debt instrument is significant. [FN29] In the case of modifications not specifically described in the Regulations a general rule applies; that is, "a modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." [FN30] In the case of changes in current interest payments, the Regulations specifically provide that a change in the yield is a significant modification if the modified rate varies from the original rate by more than the greater of 1/4 of one percent (25 basis points) or 5 percent of the annual yield of the unmodified instrument. [FN31]

One excellent feature of the 1.1001-3 Regulations is that they limit the effect of multiple changes. Thus, if the changes individually would not be a significant modification under the rules set forth therein, they will not collectively constitute a significant modification. [FN32] For example, if neither an interest rate change nor the extension of the final maturity of a debt instrument were deemed significant modifications under the *294 rules set forth in the Regulations, they would not collectively constitute a significant modification.

Subsequent Events

Subsequent to publishing the Proposed Regulations under Section 1001, but prior to promulgation of the Final Regulations, the Service issued Letter Ruling 9412013, [FN33] where the holder of old debentures (H) originally acquired in a 1989 taxable exchange for taxpayer's (T) stock reported the gain realized on the exchange utilizing the installment method of accounting. In 1992, as a part of a reorganization T offered to exchange other debt and equity securities (consisting of shares of T's common stock) with H for T's old debentures. In addition, H would receive the right to and receipt of a tax payment equal to the amount of any federal and state income taxes due as a result of the exchange. While the maturity date for both the old and new debentures was the same, the principal amount and adjusted issue price of the new debentures was significantly less than the old debentures and the various escalating interest rates on the new debentures were, on average, at least 2 percent lower than the interest rate on the old debentures. In addition, while the old debentures were convertible into common stock of T, the new debentures were not.

Citing Revenue Ruling 73-423, [FN34] the Service found that H's receipt of T's stock and the tax payment were installment payments made to H for purposes of Section 453, and that H must report the fair market value as a payment on the old debentures. Citing additional authority, [FN35] the Service determined that the change in the interest rate would not result in a disposition or satisfaction under Section 453B.

Regarding the elimination of the conversion feature, the Service discussed Revenue Ruling 82-188, where the Service had ruled that the exchange of a note that was convertible into common stock of the seller for a note that was not convertible but had a substantial increase in face value constituted a disposition of the note under Section 453B.

In contrast to the waiver of the conversion feature in Revenue Ruling 82-188, which allowed the taxpayer to lock in the appreciation in the underlying common stock, in Letter Ruling 9412013 the Service found that, because the conversion feature was of virtually no value at the time of the exchange, its elimination would result in no change to H's economic *295 position. Therefore, the Service ruled that the change in the interest rate and elimination of the conversion feature (provided that it was of virtually no economic value) would not be considered a satisfaction or disposition of the old debentures within the meaning of Section 453B.

The most interesting thing about Letter Ruling 9412013 is that the Service referred solely to rulings that were issued before the publication of the Proposed Regulations. Neither Cottage Savings nor the Proposed Regulations, both of which were published when the letter ruling was issued, were referenced or discussed.

Conclusion

Most importantly, will Ms. Johnson have to recognize the gain inherent in her installment sale obligation upon its modification? It is not entirely clear. Before Cottage Savings there would have been little doubt that merely changing the interest rate would not have been a material alteration of the installment obligation. If, however, the Regulations under Section 1001 are relevant to the analysis under Section 453B, the changes to Johnson's installment sale obligation may cause a deemed disposition requiring recognition of her deferred installment gain.

Examination of the many examples contained in the Regulations dealing with the modification of debt instruments, support the view that Johnson's changes would be a modification of the instrument and are substantial enough to cause a deemed disposition under Section 1001. Whether this would also cause a deemed disposition for purposes of Section 453B has not been resolved.

However, the Service's response to a taxpayer's specific request in a private letter ruling, occurring after the Proposed Regulations were published, may support the contention that the Final Regulations will not apply for purposes of Section 453B. It appears that the Service has followed Treasury's express comments in the preambles to both the Proposed and Final Regulations that a determination that there is a sale or disposition under Section 1001 does not determine that there has been a disposition of an installment sale obligation under Section 453B. Perhaps Congress should follow the lead of the Treasury and the Service and create some clarity in this another confused area of the tax law.

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[FN1] I.R.C. ss 453(a); 453(b)(1); and 453(c).

[FN2] I.R.C. s 453(a).

[FN3] I.R.C. s 453B(a)(1).

[FN4] I.R.C. s 453B(a).

[FN5] I.R.C. ss 453B(a)(1), 453B(a)(2).

[FN6] I.R.C. s 453B(b).

[FN7] I.R.C. s 453B(a)(2).

[FN8] I.R.C. ss 691(a)(4), 691(a)(5).

[FN9] Transfers of installment obligations between spouses incident to divorce are governed by the nonrecognition provisions of s 1041.

[FN10] I.R.C. s 453B(g).

[FN11] Rev. Rul. 82-188, 1982-1 C.B. 90.

[FN12] 1982-1 C.B. 90.

[FN13] Rev. Rul. 87-19, 1987-1 C.B. 249.

[FN14] Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991).

[FN15] Rev. Rul. 68-419, 1968-2 C.B. 196.

[FN16] LTR 8932011.

[FN17] 1974-1 C.B. 115.

[FN18] Rev. Rul. 55-5, 1955-1 C.B. 331.

[FN19] Reg. s 1.1001-1(a).

[FN20] 57 Fed. Reg. 57034 (Dec. 2, 1992).

[FN21] 61 Fed. Reg. 32926 (June 26, 1996). The Final Regulations apply to alterations of the terms of a debt instrument on or after September 24, 1996. Reg. s 1.1001-3(h). "Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996." Id.

[FN22] Reg. s 1.1001-3(b).

[FN23] Reg. ss 1.1001-3(c), 1.1001-3(e).

[FN24] Reg. ss 1.1001-3(d), 1.1001-3(g).

[FN25] Reg. s 1.1001-3(c).

[FN26] Reg. s 1.1001-3(c)(2).

[FN27] Reg. s 1.1001-3(c)(4).

[FN28] Reg. s 1.1001-3(c)(5).

[FN29] Reg. s 1.1001-3(e).

[FN30] Reg. s 1.1001-3(e)(1).

[FN31] Reg. s 1.1001-3(e)(2)(ii).

[FN32] Reg. s 1.1001-3(f)(4). However, two or more modifications of a debt instrument over a period of time (the Regulations set a five year look-back) constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification. Reg. s 1.1001-3(f)(3). Furthermore, under the general rule used to determine significance, all modifications to the debt instrument are considered collectively so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant. Reg. s 1.1001-3(e)(1).

[FN33] While private letter rulings are directed only to the taxpayer that requested it and can not be used or cited as precedent (I.R.C. s 6110(j)(3)), they provide insight into what position the Service may currently be taking in an area.

[FN34] 1973-2 C.B. 161.

[FN35] Rev. Rul. 68-419, 1968-2 C.B. 196; Rev. Rul. 82-122, 1982-1 C.B. 80; Rhombar Co. v. Comm'r, 47 T.C. 75 (1966).