milestone

The 453 Plan Guide

Introduction

In the realm of tax and financial planning, various strategies can make the sale of an asset more favorable. One of these methods, especially pertinent to business transactions, is the 453 installment plan. Rooted in Section 453 of the Internal Revenue Code (IRC), the 453 installment plan allows sellers to recognize gains over an extended period rather than immediately upon sale. This guide dives into its origins, its legal foundations, its inherent benefits, and some of its important considerations.

Historical Context and Genesis

Section 453 of the Internal Revenue Code elucidates the provisions of the installment sale method—a strategic fiscal tool tailored for sellers, especially those in the business arena. But to understand its true essence, one must consider the historical, economic, and policy implications that drove its conception.

The 453 installment sale mechanism wasn't born in a vacuum; it was the result of systemic fiscal observations and an understanding of the challenges sellers faced in the complex business milieu. Historically, the world of trade has thrived on fluidity and the ease of transaction. A business, when on the cusp of selling an asset, often faced the conundrum of immediate taxation versus a staggered payment structure from the buyer. This inherent conflict in cash flow against tax liability led to economic inefficiencies and often acted as a deterrent to potential transactions.

Liquidity and Cash Flow Management

The fundamental catalyst behind the installment sale mechanism was the necessity to synchronize tax liabilities with actual cash flows. Imagine a scenario wherein a business decides to sell a pivotal asset. The buyer, given the magnitude of the investment, opts for a multi-year payment plan. Despite receiving just a fraction of the sale proceeds in year one, the seller was, in the absence of Section 453, obligated to recognize the entire gain and subsequently pay tax on a profit not yet realized. This mismatch was not just an accounting conundrum but could strain the seller's liquidity, sometimes to breaking points.

Stimulating Economic Transactions

At its core, the U.S. fiscal policy has oscillated between revenue collection and economic stimulation. The 453 installment method was a potent tool in the latter arsenal. By offering a tax deferment mechanism, the policymakers intended to inject vigor into the transactional ecosystem. The logic was straightforward: by providing sellers an avenue to defer taxes in line with actual cash receipts, potential barriers to asset sales would diminish. This would inevitably lead to a more vibrant market with increased buying and selling activities.

Enhancing Flexibility and Expanding Opportunities

The world of business isn't black and white. Transactions are often laced with nuances, and buyer-seller dynamics can be complex. Recognizing this, the architects of the IRC's Section 453 aimed to offer a higher degree of transactional flexibility. By allowing sellers to recognize gains over the tenure of the payment plan, the provision inadvertently bolstered seller-financed sales. This proved to be a double-edged sword favoring both parties. Sellers could now tap into a broader buyer base, including those who couldn't afford immediate lump-sum payments. Simultaneously, buyers, especially burgeoning businesses or those without immediate access to large financing, found a more accessible market.

Mitigating Risks

Business is inherently risky, and the realm of asset sales is no exception. One of the veiled advantages of the installment method was risk mitigation. When a seller opts for a staggered payment structure, there's always the looming risk of buyer default. However, by recognizing gains over time, the seller would not find themselves in the precarious position of having paid taxes on unrealized or worse, unreceived gains.

In conclusion, the 453 installment sale provision is more than just a tax code—it's a testament to the evolving nature of fiscal policy, tailored to address real-world business challenges. Conceived as a solution to cash flow anomalies, it quickly morphed into an economic stimulant, a flexibility enhancer, and a risk mitigator. As the business landscape continues to transform, the utility of such fiscal tools underscores the intricate dance between policy-making and practical economic challenges. It's a reminder that regulations, at their best, are enablers, smoothing the pathways of commerce and growth.

Legal Framework of the 453 Installment Plan

Under 26 U.S. Code §453, income from an installment sale shall be considered under the installment method of accounting, which only recognizes income in the period in which payment was actually or constructively received by the taxpayer.[1]

[1] 26 U.S. Code § 453

An amount is considered constructively received:

> in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.[2]

To qualify as an installment sale (and therefore the installment method of accounting), the IRC requires that "at least one payment... be received after the close of the taxable year in which the disposition occurs."[3] Note, when the purchaser is willing to pay the total contract price in the year of sale, the sale still qualifies as an installment, as long as payment is received in a tax year after the year of sale.[4] A payment is considered paid in the taxable year in which it is actually or constructively received, or payable on demand.[5]

If a sales purchase agreement confers the right for either party to receive payment through a nonqualified installment structure, then the structure and subsequent installments may be used. This obligation provides that a buyer may obtain a nonqualified funding asset or assets to fund installment payments. The nonqualified funding assets may include cash deposits, bonds, or other investment assets tied to broad-based benchmarks, such as ETFs issued by a financial institution and their financial advisors.

It is important to remember that Section 453 of the IRC also explicitly sets forth various criteria and guidelines for the 453 plan. First, the installment method can only be used for sales of real property and certain personal property that is not inventory.[6] This means that businesses primarily earning from the sale of inventory typically cannot utilize this method. Further, to qualify for the installment method, at least one payment must be received after the tax year in which the sale occurs.[7] This requirement ensures that a portion of the sale price is genuinely deferred. The installment method is elective and not mandatory.[8] Sellers have the option to recognize the entire gain in the year of

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[2] Internal Revenue Service (IRS) Publication 17, "Your Federal Income Tax" (2021).

[3] IRC §453(b)(1).

[4] Rev. Rul. 73-396, 1973-2 C.B. 160.

[5] Internal Revenue Service (IRS) Publication 538, "Accounting Periods and Methods" (2021)

[6] Khioe, S. (2023). Accounting for income tax. SSRN Electronic Journal.

https://doi.org/10.2139/ssrn.4518319

[7] JONES, S., RHOADES-CATANACH, S., & Lemler, B. (2010). Principles of taxation for business and investment planning. Issues in Accounting Education, 25(3), 599-600.

[8] Khioe, S. (2023). Accounting for income tax. SSRN Electronic Journal. https://doi.org/10.2139/ssrn.4518319

the sale if they prefer. This choice provides flexibility based on individual financial circumstances.

IRC 453 has been a well-established law for over 90 years and is a well-recognized tax deferral tool.[9] The IRS (Internal Revenue Service) has also held the position that there is no constructive receipt when a taxpayer is under the restrictions of a 453 plan.[10] To prevent potential abuse, the Internal Revenue Code has implemented rules for sales between related parties.[11] These rules ensure that the benefits of the installment method are not unfairly exploited through structured transactions within families or entities.

As Robert W. Wood has explained, however, 453 plans are not problematic from a tax perspective and there's little chance the IRS would ever attack them in the future.[12] Overall, the installment method is a tax accounting method with strong legal backing that allows for the recognition of income from a sale over multiple years, rather than in the year of the sale.

453 Plan Alternatives

Lump Sum Receipt

The standard method of payment for the sale of an asset or investment property is lump sum distribution. The main benefit to a lump sum receipt is that proceeds become immediately available for use by the seller. This benefit is especially important during times of market volatility because proceeds can be invested into broader/diversified markets.

Unfortunately, when payments are received in a lump sum, taxes are recognized in the year the sale is made.[13] This means that a seller's tax liability will spike in proportion with the size of the sale amount/gain if the lump sum method is used. With high dollar property sales, this method of tax recognition has the potential to wipe out the value of an otherwise lucrative transaction.

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[9] MetLife. *Structured Installment Sales.*

[10] Regs. §1.1031 (k)-1 (f)(2)

[11] (2020). Accounting for income taxes. https://doi.org/10.1002/9781119743439.ch10

[12] Rob Wood. *Structured Sale: Breathing Life into Installment Sales.*

[13] The Tax Adviser. *What Does the New Revenue Recognition Standard Mean for Tax?*

1031 Exchange

Historically, the main competitor to the standard lump sum receipt has been the 1031 exchange.[14] The 1031 exchange allows a seller to defer taxes on the sale if the proceeds are reinvested into the property market.[15] The properties must be classified as like-kind, and properties must be purchased and sold within the same country.[16] Additionally, Section 1031 requires that a seller must select a new investment property within 45 days and complete the sale within 135 days after said property has been selected.[17] On their own, this requirement is burdensome for a seller looking to defer their investment gains. In a volatile investment market, these restrictions can be even more detrimental. Such volatility is being felt today, and so, the 1031 solution cannot be the workaround for lump sum distributions. Even if there was a strong present investment economy, the additional like-kind requirements for a 1031 exchange limits a seller's options for deferring their gains.

453 Plan Advantages

A 453 plan allows a property seller to place the proceeds of a sale into a market backed entity investment account.[18] This entity investment account will pay out to the seller over a period of years, effectively avoiding constructive receipt and taxation until the payments are disbursed. Unlike the 1031 exchange, there is flexibility for the property seller to reinvest property sale proceeds in other markets. The seller is guaranteed a set schedule of payments, which will fluctuate depending upon the performance of the investment account.

For the foregoing reasons, the 453 Plan is the best solution for property sellers looking to grow the proceeds of their property sales through tax deferral, without being unduly constrained in their reinvestment alternatives.

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[14] American Land Title Association. *The Tax and Economic Impacts of Section 1031.*

[15] 26 U.S. Code § 1031.

[16] IRS. *Like-Kind Exchanges*. 2023.

[17] 26 U.S. Code § 1031(a)(3).

[18] Oklahoma Bar Journal. *Deferred Sales Trust - What's All the Hype?*

453 Considerations

While the 453 installment plan offers numerous benefits, sellers should also be aware of these considerations:

Deferred Tax Payment Rule

Under the regulations, a seller may be required to pay additional interest on a portion of their deferred tax liability.[19] The rule applies to an installment obligation received by the seller from the buyer during the taxable year of the sale, provided the obligation remains outstanding as of the close of such taxable year and, provided further, that the face amount of such outstanding obligation exceeds $5 million.[20] If a seller is required to pay interest in accordance with this rule, then the taxpayer will be required to pay interest for every subsequent taxable year at the close of which any part of that obligation remains outstanding.[21] Thus, even if the amount that remains outstanding under the obligation has dropped below $5 million, the interest charge will still apply.[22] The amount of interest payable for a taxable year in which the special interest rule applies is determined by applying the tax deficiency rate to the amount of the deferred tax liability attributable to that portion of the obligation in excess of $5 million.[23] The deferred tax liability for such taxable years is calculated by multiplying the amount of the unrecognized gain attributable to the obligation as of the close of the taxable year, by the maximum rate of tax applicable to the taxpayer for that year.[24]

Future Tax Rates

One of the perceived benefits of an installment sale is the deferral of taxes. Instead of recognizing the full gain in the year of the sale, the gain is spread out over several years. While this deferral can offer short-term tax savings, it also exposes the seller to the risk of future tax rate changes. Tax laws and rates are not static. They change based on various factors, including shifts in political leadership, economic conditions, and policy objectives. If you've entered into a long-term installment sale agreement and tax rates rise significantly in the future, the deferred gains could end up being taxed at a much higher rate than if they had been recognized upfront. This uncertainty makes financial and tax planning challenging. While deferring gains might seem beneficial in the short term, the risk of future tax rate hikes could negate those benefits in the long

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[19] IRC Sec. 453A(a)(1).

[20] IRC Sec. 453A(b)(2).

[21] H.R. Rep. No. 100-495, at 929 (1987).

[22] See Id.

[23] IRC Sec. 453A(c)(4).

[24] IRC Sec. 453A(c)(3).

run. Over time, inflation and changing interest rates can erode the real value of future payments.

Interest Rate Fluctuations

Installment sales typically involve interest payments. This interest is income to the seller and is taxed as ordinary income, not capital gains. The rate must be reasonable; otherwise, the IRS might impute a rate, which could lead to unexpected tax consequences. First, the interest rate can be a point of contention between the buyer and seller. If set too high, it might strain the buyer's finances, increasing default risk. If set too low, the IRS might view it as a below-market loan, which brings about imputed interest and potential adverse tax consequences. Sellers might mistakenly believe they can avoid this by not charging interest, but the IRS rules are designed to prevent this kind of tax avoidance. The combination of ordinary income tax rates on interest and capital gains rates on the principal portion can make the tax calculations and reporting more complex and could lead to a higher overall tax liability than anticipated.

Further, when structuring an installment sale, the interest rate on the installment note is typically fixed at the outset. If the interest rate established at the beginning of the installment agreement is lower than future prevailing rates, sellers might find themselves facing significant opportunity costs. The funds they receive from the installment sale could have been invested elsewhere at a higher rate, leading to potentially higher returns. This is particularly pertinent in environments where inflation is rising, eroding the real value of the fixed payments the seller receives.

Lastly, if the interest rates on other forms of credit rise (e.g., bank loans), the buyer might find their other borrowing costs increasing. This can strain their liquidity, making it more challenging to meet the obligations of the installment note. In cases where the buyer was relying on refinancing options to meet future installment payments, higher prevailing interest rates could jeopardize their ability to secure favorable refinancing terms. This point leads to the next potential pitfall, or lack thereof.

Risk of Insolvency

Some scholars point to the potential risk that either the buyer or the 453 administrator might default.[25] This should not be viewed as a risk for 453 plans, even if Milestone or GPAAC is facing insolvency. In the event that Milestone ceases to operate and/or do business, Milestone will authorize GPAAC to distribute the entire present value of the sale amount to payee in order to satisfy their obligation pursuant to this agreement.[26] The unfortunate reality of this event would be that the property seller will have to pay the

[25] Equity Risk Incentives and Corporate Tax Aggressiveness. Rego, Wilson. 2012. *Journal of Accounting Research.*

[26] See Id.

taxes on the entire lump sum that is being distributed.[27] Further, the IRS might say that, because the structured payment method was not followed, the property seller might have to pay back taxes on the value of the initial sale.[28] Regardless of Milestone's insolvency, the property seller will receive their sale proceeds. The only risk is the amount of tax that may be forced to pay.

Conclusion

The 453 installment plan, enshrined in the IRC, offers an elegant solution for sellers seeking tax efficiency and financial flexibility. Its creation stemmed from a need to balance taxation with cash flow, stimulate economic activity, and offer transactional adaptability. Legally robust and grounded in practicality, this method stands as a testament to strategic tax planning. However, like all financial strategies, it's not one-size-fits-all. Sellers must evaluate their unique circumstances, consult with tax professionals, and weigh the benefits against any potential pitfalls. In many scenarios, however, the 453 installment plan remains the superior and most compelling tax strategy, especially in the context of business sales.

[27] See Id.

[28] See Id.