

Real Estate Developer Defends Personal Installment Sales

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By Erin McManus

A California contractor, developer, and builder and his wife are challenging the IRS's application of the codified economic substance doctrine to monetized installment sales.

The couple's argument that the doctrine doesn't apply to their monetized installment sale in *Harty v. Commissioner* may make their [memorandum](#) in support of partial summary judgment filed in the Tax Court August 23 noteworthy for those involved with similar transactions.

The summary judgment motion and memorandum followed the August 3 [inclusion](#) of the transaction to the IRS's "Dirty Dozen" list of potentially abusive tax arrangements, which in turn followed an unusually detailed amended [answer](#) filed October 20, 2022.

In the answer, the IRS laid out its argument against the claimed tax benefits of the transaction under [section 453](#).

In a normal installment sale, cash payments are made over a period of years, and the seller doesn't have to immediately recognize gain.

Tom Cullinan of Chamberlain, Hrdlicka, White, Williams & Aughtry told *Tax Notes* that Nat and April Harty's memorandum did a good job of crystallizing some discreet legal issues: First, Congress intended [section 453](#) to apply to this type of transaction, and second, the IRS's arguments aren't grounded in economic substance but in the step transaction or substance-over-form doctrines.

Cullinan added that the memorandum was "thorough and well written and could create some precedence. Anyone involved should keep an eye on it."

David J. Slenn of Akerman LLP said, "The IRS's answer gives everyone an idea of what the IRS is going after — and it's not the run of the mill installment sale used in estate planning."

"What planners do in regular estate planning should not be substantially similar to this transaction," according to Slenn.

Slenn anticipates that the planning community may argue that the transaction will destroy perfectly legitimate installment sales.

Slenn compared promoters of monetized installment sales with "microcaptive insurance promoters who tried to get the big captive insurance industry behind them" but failed to get the *Fortune* 500 to do so.

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The IRS said the purpose of the monetized transaction sale “is to allow the buyer to be involved in a straight sale, give the seller installment sale treatment, but still give the seller nearly all of the purchase price in cash immediately via a loan from a related lender.”

The Hartys said Congress has never imposed limits on a taxpayer choosing to do an installment sale when a buyer is willing to pay cash.

Seven-Step Transaction

The IRS accompanied the Dirty Dozen listing with proposed regulations ([REG-109348-22](#)) establishing seven steps involved in the monetized transaction sale, which were apparently consolidated after 14 steps were identified in the amended answer.

The first step is for the seller of appreciated property to identify a buyer. The Hartys did this, finding buyers able and willing to pay cash for the following properties:

- a 51 percent interest in an industrial warehouse purchased in 1985 for \$27,080 and sold through an installment sale in 2016 for \$717,815 with an adjusted basis of \$27,080 (the same amount as the cost basis);
- a residential property purchased in 2004 for \$825,037, rented to unrelated parties and sold for \$718,269 in 2016 with an adjusted basis of \$549,758; and
- a property originally purchased in 2003 as a single-family residence for \$1.35 million, subsequently converted to a condominium for business purposes and sold for \$3.52 million with an adjusted basis of \$516,269.

The loan amount is purportedly paid to the seller, while the promoter makes the first installment payment. This payment is sent from the seller to the lender and then back to the promoter, and continues to circulate in the same order for the life of the loan.

The IRS noted that there was no economic risk, as would normally arise in an installment sale, because the seller has already been fully paid.

It also observed that all installment payments were made through journal entries with no funds ever physically changing hands.

Lack of Economic Substance

The IRS argued that the transaction lacked economic substance under [section 7701\(o\)](#) because it didn't change the Hartys' “economic position in a meaningful way apart from federal income tax effects (the objective prong).”

Furthermore, the transaction failed the subjective prong economic substance test because the Hartys had no “substantial purpose for entering into the transaction apart from federal income tax effects.”

The IRS noted that without the tax benefit, the Hartys are worse off financially by entering into the transaction.

The installment sale option exists so the seller only recognizes gain as sale proceeds are received from the buyer. The Hartys could have sold the properties directly to the buyers — who were willing to pay — rather than the promoter, the IRS said.

Slenn said he thinks that *Harty* might finally result in some [section 6662\(i\)](#) case law on substantive grounds instead of [section 6751\(b\)](#) managerial approval losses on technical grounds.

“While public attention is focused on the IRS’s attempt to draw a line as to what it finds abusive with [monetized installment sales] — which will be relevant for notice and comment rulemaking associated with the reportable transaction — few may take note of the IRS’s attempt to develop a penalty that has much broader application to noneconomic substance transactions,” Slenn said.

The transaction was marketed by Stanley Dean Crow of S Crow Collateral Corp., who operates out of his Boise, Idaho, home.

The Hartys said that S Crow Collateral was designated as a qualified intermediary, and their use of an intermediary to qualify for installment sale treatment isn’t inconsistent with the plain intent of [section 453](#).

When asked if that transaction could be unwound to limit penalties, Cullinan said it depends on timing. A taxpayer can file a qualified amended return to change its position, but the amended return must be filed before a [section 6700](#) audit is initiated.

The petitioners in *Harty v. Commissioner*, Dkt. No. 23354-21 (T.C. 2023), are represented by Roger Glienke and Dennis N. Brager of Brager Tax Law Group.