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Comment*

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I. INTRODUCTION

The installment sales provisions of the Internal Revenue Code[1] allow a taxpayer to defer the recognition of income realized from a sale of property. Ordinarily, the profit realized on the sale of property is recognized as income in the year of sale.[2] However, when the sale proceeds are received in installment payments over several tax years, the seller may not have cash available in the year of sale to pay the tax on the total profit realized. The purpose of the installment sales provisions is to relieve the taxpayer from the inequity of requiring immediate recognition of taxable gain when he has received only a portion of the sale proceeds.[3] The Code allows the seller to recognize and report as income a percentage[4] of each deferred installment payment he receives; the remainder is a return of basis.[5] In this way, the recognition of income may be deferred to the time of the actual payments, and the tax on the profit from the sale of the property may be paid out of the sale proceeds as they are received.

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1. I.R.C. §§ 453, 453A, 453B (Supp. IV 1980).
2. I.R.C. §§ 1001(a)-(c) (amount realized), 451(a) (timing of gain realized) (1976).
3. Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 503 (1948).
4. The gross profit ratio is the gross profit realized or to be realized divided by the total contract price. The contract price is equal to the total sale price minus the amount of any mortgage or other indebtedness encumbering the property which the buyer assumed or took subject to and which does not exceed the seller's basis in the property. *See* Temporary Treas. Reg. § 15a.453-1(b)(2), 1981-10 I.R.B. 13.
5. A taxpayer's basis in property is generally equal to the historical cost of the property to the taxpayer. I.R.C. § 1012 (1976). The adjusted basis for calculating gain or loss on a transaction involving the property is the cost of the property adjusted by the applicable provisions of I.R.C. § 1016. The most common adjustment is the reduction of the property's basis for the depreciation deduction taken with respect to the property.

The installment sales provisions have been a part of the Internal Revenue Code since 1926.[6] However, until the recent congressional enactment of the Installment Sales Revision Act of 1980,[7] the benefits of the installment method were difficult to obtain. The taxpayer had to affirmatively elect installment treatment in a timely manner,[8] and there were several conditions which, if violated, disqualified the sale from the benefits of installment reporting.[9] For example, an installment was defined as one of two or more payments, and a sale requiring a single future payment did not qualify.[10] The most onerous disqualifying provision was the thirty percent initial payment limitation,[11] which rendered installment treatment unavailable if more than thirty percent of the selling price was received in the year of sale. This provision was more easily violated than might appear because the selling price was subject to downward adjustment for imputed interest,[12] while the

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6. *See* Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 23.
7. Pub. L. No. 96-471, 94 Stat. 2247 (1980) [hereinafter referred to as the Act].
8. The determination of what constituted a timely manner turned out to be a complicated legal issue. The regulations required that election be made in a timely filed tax return for the year of sale. Treas. Reg. § 1.453-8(b)(1960). However, several exceptions to this requirement developed. *See* Estate of Lipman v. United States, 376 F.2d 455 (6th Cir. 1967) (election made in amended return allowed); Yellow Cab & Car Rental Co. v. Commissioner, 33 T.C.M. 413 (1974) (election made in late return allowed); Spivey v. Commissioner, 40 T.C. 1051 (1963) (election made in later year than that in which first installment was received allowed).
9. *See* Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 471, 478-96 (1975). For a particularly egregious example of the potential inequities under the prior law, see Mitchell v. Commissioner, 42 T.C. 953 (1964). In *Mitchell* the taxpayer received section 1031 "like-kind" property and boot in exchange for his property. Boot is cash, securities, or other non-like-kind property which does not qualify for the non-recognition treatment of section 1031. A taxpayer under both the prior and present law could elect to treat boot under the installment method. However, under the prior installment sales provisions, if the *nonrecognition property plus boot* which was exchanged for the property sold had a value of more than 30% of the selling price of the property, the election was lost. In other words, nonrecognition property was treated as *money received* in the year of sale for purposes of section 453. *Id.* at 965. This was true even though no gain was recognized on the exchange of the like-kind property. In *Mitchell*, the only boot received, other than the installment note, was approximately $7000 cash, an amount far less than 30% of the sale price. Nevertheless, treatment of the like-kind property as money received precluded the taxpayer from using the installment method. *Id.*
10. Baltimore Baseball Club, Inc. v. United States, 481 F.2d 1283 (Ct. Cl. 1973).
11. *See* Ginsburg, *supra* note 9, at 482.
12. *See, e.g.*, Robinson v. Commissioner, 54 T.C. 772 (1970), *aff'd*, 439 F.2d 767 (8th Cir. 1971) (illustrating the potential effect of imputing interest into a contract which did not provide for interest). Under section 483, unless interest is specified in the installment contract at a rate of 9% (simple interest) it will be imputed at a rate of 10% (compounded semi-annually). The interest is treated as if it were included in the contract price by the parties as interest,

calculation of the payment received in the year of sale was not. After such a reduction in the selling price, the constant year of sale payment represented a larger percentage of the selling price. Thus, in situations where the payment received in the year of sale approached thirty percent of the original sale price, the transaction was disqualified from installment sales reporting upon downward adjustment of the sale price.[13]

In response to the complexity of and general dissatisfaction with the old installment sales provisions, Congress enacted the Installment Sales Revision Act of 1980.[14] While the underlying purpose and operation of the statute were not changed, many of its shortcomings were corrected.[15] The two-payment rule and the thirty percent initial payment limitation were expunged from the statute.[16] Recognizing that most taxpayers desired the benefits of installment method treatment, Congress made it automatic.[17] Under the new law, a taxpayer must elect out of rather than into the installment provisions.[18] The other changes Congress provided generally simplify the installment provisions and make them more consistent with other Code provisions and with broader tax policy.[19]

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and as a result the sale price will be lowered. *See* I.R.C. § 483 (1976). Original issue discount also is not deemed a part of the actual selling price, and if present, it will reduce the stated selling price. Temporary Treas. Reg. § 15a.453-1(b)(2)(ii), 1981-10 I.R.B. 13. Original issue discount results when a bond is purchased from the issuing entity at less than its stated face amount. The difference between the purchase price and the face amount of the bond is original issue discount, and it is treated as interest for most purposes. *See, e.g.*, I.R.C. §§ 454, 1232(a)(2)-(3) (1976).

13. The technical nature of the prior installment sales provisions often resulted in the loss of installment treatment simply because the taxpayer did not obtain good tax planning advice. *See* Ginsburg, *supra* note 9, at 474-96.
14. S. REP. NO. 1000, 96 Cong., 2d Sess. 2-7 (1980), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4696, 4697-4701 [hereinafter cited as SENATE REPORT].
15. *Id.* at 7-8, 1980 U.S. CODE CONG. & AD. NEWS at 4701-02.
16. *See* Mylan, *The Installment Sales Revision Act of 1980*, 17 WILLAMETTE L. REV. 303, 304-08 (1981).
17. *See* Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 N.Y.U. INST. ON FED. TAX'N § 43.02(4) (1981).
18. SENATE REPORT, *supra* note 14, at 12, 1980 U.S. CODE CONG. & AD. NEWS at 4706-07.
19. For example, the Act makes sales for future payments which are contingent in amount eligible for reporting under the installment method; it allows shareholders who receive installment obligations pursuant to a section 337 corporate liquidation to use the installment method in reporting gain from payments received on those obligations, if the obligations were procured by the corporation in furtherance of a section 337 plan of complete liquidation; and it provides that section 1031 like-kind property is not to be treated as a payment received in the year of sale in the installment calculation. For a more extensive discussion of these and other changes made by the 1980 Act, see Allison & Latham, *Installment Sales Revision Act of 1980—Important*

One important issue which has survived the passage of the Installment Sales Revision Act is the necessity of determining whether and to what extent the taxpayer has received payment in the year of sale.[20] Under the prior law, this determination had dual significance. First, taxable income was calculated as a percentage[21] of payments received in the year of sale. Second, if more than thirty percent of the adjusted sale price was received in the year of sale, the transaction was disqualified from installment reporting.[22] Although the current law has eliminated the thirty percent limitation, taxable income is still calculated as a percentage of payments received in the year of sale.[23] The determination of the

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Changes for the Practitioner, 10 STETSON L. REV. 453 (1981); Colleran & Rosenthal, *An analysis of the Installment Sales Revision Act of 1980*, 12 TAX ADVISOR 4 (Jan. 1981); Emory & Hjorth, *An analysis of the changes made by the Installment Sales Revision Act of 1980—Part I*, 54 J. TAX'N 66 (1981); Emory & Hjorth, *Installment Sales Act, Part II: cost recovery, 337 liquidations, related parties, dispositions*, 54 J. TAX'N 130 (1981); Ginsburg, *supra* note 17; Mylan, *supra* note 16.

20. *See* Emory & Hjorth, *An analysis of the changes made by the Installment Sales Revision Act of 1980—Part I*, 54 J. TAX'N 66, 66-67 (1981).
21. Treas. Reg. § 1.453-5(a) (1958).
22. *See* Emory & Hjorth, *supra* note 20, at 66; Ginsburg, *supra* note 9, at 482 n.41.
23. Temporary Treas. Reg. § 15a.453-1(b)(2)(i), 1981-10 I.R.B. 13. *See* Emory & Hjorth, *supra* note 20, at 67; Mylan, *supra* note 16, at 308. The percentage of payments treated as income is the gross profit percentage multiplied by the payments received. Gross profit percentage is defined in the temporary treasury regulations. *See* Temporary Treas. Reg. § 15a.453-1(b)(2), 1981-10 I.R.B. 13; *supra* note 4.

The regulation definition is premised on the belief that a purchaser will discharge an assumed mortgage. If the premise is correct, the regulation accomplishes its purpose of allowing the seller to spread his gain over the payments he receives. If the sale price were not reduced by the amount of an assumed mortgage, the gross profit ratio would be too low and the seller would evade a portion of his tax liability. *See* Burnet v. S. & L. Bldg. Corp., 288 U.S. 406 (1933). For example, assume A sold B property for $200,000 with a basis of $100,000 and subject to a mortgage of $100,000. A received $25,000 cash and a note for $75,000, payable ratably over three years and secured by a second mortgage on the property. B paid the mortgagee directly, $25,000 per year for four years beginning with the year of sale. The gross profit calculation should be: gross profit of $100,000 divided by the contract price of $100,000 ($200,000 selling price minus $100,000 assumed mortgage), yielding a gross profit ratio of 100%. A should be taxed on the full $25,000 he received each year ($25,000 x 100%). In contrast, if the contract price were not reduced by the $100,000 assumed mortgage, the gross profit ratio would be 50%, ($100,000 divided by $200,000) and would be designed to apply to the situation where the purchaser, B, did not pay the mortgagee directly but rather paid the full purchase price, $50,000 per year, to the seller. If only $25,000 were in fact shown on the seller's return, one-half of the gain would escape tax. However, if $50,000 did pass through the seller's hands and was reported on his tax return, the 50% gross profit ratio would be correct, and the gain on the sale would be fully taxed to the seller at the rate of $25,000 per year. The point is that the mechanics of the statute and its purpose of spreading gain over pay-

extent of payment in the year of sale may assume even more importance because of the automatic applicability of installment treatment and the removal of the technical disqualifying provisions. Simplification in these areas will shift tension from technical disqualification to the more basic issue of the extent of payment received in the year of sale.[24]

The stakes involved in receipt of payment situations range from a progressively greater recognition of income in the year of sale, as the taxpayer is deemed to have received a larger payment, to the effective denial of section 453 treatment when the total selling price is deemed to have been received and recognized in the year of sale. This Comment will discuss two types of transactions where the determination of the extent of receipt of payment is important. The first transaction involves the use of a wraparound mortgage as security for the seller of real property.[25] The second transaction involves the use of a standby letter of credit to secure payment for property sold by the seller.[26] Although both types of transactions provide the seller of property security against default by his buyer, the taxation analysis differs in each case. Fundamental to both analyses, however, is the premise that when the security for a transaction becomes too assured, the security will be treated as the equivalent of an actual payment.

This Comment will outline the probable present status of the wraparound mortgage and the letter of credit after the Installment Sales Revision Act of 1980.[27] It will also examine temporary regulations[28] promulgated pursuant to the Act which address, to some extent, both types of transactions. This Comment will discuss

ments received do not depend on whether property is taken subject to a mortgage, but rather on whether the seller actually receives and reports as income the yearly payments that it was assumed would be received when the gross profit ratio was calculated. In the wraparound mortgage situation where mortgage liability is in excess of basis, this point is of fundamental importance. *See infra* notes 56-116 and accompanying text.

24. Under prior law, if the Service felt that an installment transaction should be taxed more fully in the initial year, there were numerous technicalities which it could use to attack the validity of the transaction. *See supra* notes 9-13 & accompanying text. Removal of the technical provisions will force the Service to make a frontal attack on disputed transactions and argue that payment for the property was actually or constructively received in the year of sale.
25. *See infra* notes 29-140 and accompanying text.
26. *See infra* notes 220-73 and accompanying text.
27. Pub. L. No. 96-471, 94 Stat. 2247 (1980). This Comment will discuss only § 453, which applies to sales of real property and casual (non-dealer) sales of personal property. Section 453A includes provisions which apply to dealer sales of personal property. I.R.C. § 453A (Supp. IV 1980). Section 453B contains rules which govern the taxation of gain on the dispostion of the installment obligation itself. *Id.* § 453B.
28. Temporary Treas. Reg. §§ 15a.453-0, .453-1(a)-(e), 1981-10 I.R.B. 13-25.

whether these two security devices can be used without serious risk of being treated as payments received in the year of sale. To the extent that the security is treated as a payment rather than as security, the taxpayer will be forced to recognize income before actually receiving the proceeds from the sale of the property.

II. WRAPAROUND MORTGAGES AS PAYMENTS RECEIVED IN THE YEAR OF SALE OF REAL PROPERTY

A. Background

A wraparound mortgage is a type of second mortgage on real property.[29] In the usual wraparound transaction, a property owner who has previously mortgaged the property resells it, taking in return a cash down payment and a second mortgage which is subordinate to that of his (senior) mortgagee.[30] The second mortgage held by the property owner secures the purchaser's promissory note for the *full value* of the property, *including* the portion which is encumbered by the senior mortgage.[31] Contrast this with the more usual case, where the purchaser gives the seller a note for value of the seller's equity in the property only, and either assumes the seller's mortgage or refinances the debt embodied in the seller's mortgage. In the case of a purchase money wraparound mortgage, the seller of the property remains liable to the senior mortgagee on the senior mortgage, and the purchaser is in turn liable to the seller to make payments on the full value of the property.[32] Each payment from the purchaser to the seller consists of two parts: a return of the seller's equity in the property and an amount equal to the debt service that the seller must make on the senior mortgage.[33] The seller is obligated to the purchaser to continue paying the debt service on the original mortgage to the senior mortgagee, even though the purchaser now owns and is in possession of the mortgaged property.[34] The seller's larger second mort-

29. *See* G. OSBORNE, G. NELSON, & D. WHITMAN, REAL ESTATE FINANCE LAW 278 (1979).
30. Before the wraparound terminology came into vogue, this method of transferring mortgaged property was recognized and, therefore, was not "invented" to circumvent the tax laws. *See, e.g.*, Simpson v. Ennis, 114 Ga. 202, 39 S.E. 853 (1901); Hazle v. Bondy, 173 Ill. 302, 50 N.E. 671 (1898); Kinney v. Heuring, 44 Ind. App. 590, 87 N.E. 1053 (1909).
31. G. OSBORNE, G. NELSON, & D. WHITMAN, *supra* note 29, at 278-79.
32. *Id.*
33. *See* Healey, *A "New" Security Instrument*, 41 CAL. ST. B.J. 681 (1966).
34. *Id.* at 684. The land held by the purchaser serves as a guarantee, while the original mortgagor has the primary duty, in the capacity of a principal, to discharge the debt. 4 AMERICAN LAW OF PROPERTY § 16.125 (A.J. Casner ed. 1952). A mortgage may function as security for a personal obligation of the mortgagor, if the parties so intend. *Id.* §§ 16.64-.65. The personal obligation survives

gage is said to be wrapped around that of the senior mortgagee because it secures his equity in the property only to the extent that the value of the property at any given time is greater than the amount of the senior mortgagee's lien.[35] Further, each payment that the seller receives from the purchaser consists of a payment for his equity in the property wrapped around the debt service that he is obligated to make to the senior mortgagee.

This type of financing arrangement has had great utility in the installment sales transaction because of the potential for deferring gain on the sale of property which is mortgaged in excess of its basis.[36] To illustrate this potential deferral of income, a discussion of the mechanics of installment reporting is necessary.

The temporary treasury regulations provide that the tax on an installment obligation is determined by multiplying the amount received in any tax year by the gross profit percentage.[37] The gross profit percentage is the gross profit to be received from the sale of the property divided by the contract price.[38] The contract price is the selling price, reduced by any mortgage or encumbrance on the property which is assumed or taken subject to by the purchaser. However, the selling price cannot be reduced by more than the ba-

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the transfer of the mortgaged property, and the mortgagor (the seller) remains either primarily or secondarily liable, unless his obligation has been discharged with the consent of the mortgagee. Hakes v. Franke, 210 Iowa 1169, 231 N.W. 1 (1930). The lien on the property, of course, follows the property into the hands of the transferee (purchaser) and is the mortgagee's ultimate protection since it may foreclose on the property to satisfy the debt. However, when the mortgagor transfers mortgaged property, a series of obligations arise which run to the mortgagee and which are layered over the underlying security of the property. 4 AMERICAN LAW OF PROPERTY, *supra*, §§ 16.124-.135. In the wraparound mortgage transaction, the original mortgagor agrees to pay off the first mortgage with funds which may be considered to come from a portion of the purchaser's payment on the wraparound note. If the mortgagor defaults on this agreement and the mortgagee threatens foreclosure on the property, the purchaser may redeem the property and either reduce his remaining obligation to the mortgagor or sue the mortgagor on a subrogation claim to recover the payments that were wrongfully not paid to the mortgagee. *Id.* § 16.146. *See* Simpson v. Ennis, 114 Ga. 202, 39 S.E. 853 (1901); Hazle v. Bondy, 173 Ill. 302, 50 N.E. 671 (1898); Hudson v. Dismukes, 77 Va. 242 (1883).

35. *See* Comment, *The Wraparound Mortgage: A Critical Inquiry*, 21 U.C.L.A. L. REV. 1529, 1530 (1974).

36. An example would be the disposition of property which has been depreciated on an accelerated method. The basis of the property would be low and part of the gain on the sale of the property would be ordinary gain because of the recapture provisions of the Code. *See* I.R.C. §§ 1250, 1245 (1976 & Supp. IV 1980). The use of a wraparound mortgage in the sale transaction would defer some of the gain from the sale.

37. Temporary Treas. Reg. § 15a.453-1(b)(2)(i), 1981-10 I.R.B. 13.

38. *Id.* § 15a.453-1(b)(2)(iii), 1981-10 I.R.B. 13.

sis of the property, even if the purchaser assumes a mortgage in excess of basis.[39] Accordingly, the temporary regulations provide that in calculating the contract price, any mortgage assumed or taken subject to by a purchaser reduces the selling price, but not by an amount in excess of basis.[40]

The purpose of the basis limitation is to ensure that the total profit on the installment sale of property will be taxed and that the profit will be ratably spread over the actual payments received by the seller.[41] The temporary regulations presume that a purchaser who assumes or takes subject to a mortgage will make direct payments on the mortgage to the senior mortgagee. As a result, fewer payments will be channeled through the seller. Therefore, the selling price must be reduced by the amount to be paid directly to the senior mortgagee to arrive at a contract price which will accurately reflect the payments received by the seller.[42] Since the gain on the sale (the numerator of the gross profit percentage) remains the same in any case, reducing the contract price (the denominator of the gross profit percentage) due to an assumed mortgage will increase the percentage of each payment which is taxable income. To avoid a gross profit percentage of more than 100%, which would result in the seller's payment of tax on more than he actually received, the contract price must not be allowed to fall below the gross profit.[43] This situation could arise only when the seller has mortgaged the property in excess of basis, because only in that event will part of the seller's *profit* on the sale be in the form of debt relief which is paid by the purchaser directly to the mortgagee.[44]

The solution to this problem which arises when the purchaser assumes responsibility for the mortgage debt, is to treat the excess of the mortgage over basis *as if* the seller had received it in the year of sale.[45] Thus, the excess is included in the contract price,

39. *Id.*
40. *Id.*
41. Burnet v. S. & L. Bldg. Corp., 288 U.S. 406 (1933).
42. Stonecrest Corp. v. Commissioner, 24 T.C. 659, 665 (1955). *See* Burnet v. S. & L. Bldg. Corp., 288 U.S. 406 (1933) (upholding the mechanics of a prior similar regulation as applied to a sale in which a buyer assumed the seller's mortgage).
43. Burnet v. S. & L. Bldg. Corp., 288 U.S. 406 (1933).
44. The profit on a sale of property is equal to the amount received less the adjusted basis of the property. The contract price is basically the amount of cash paid to the seller. In other words, it is the amount received for the property less amounts that are paid to others on the seller's behalf. When the purchaser assumes a mortgage in excess of basis, the contract price is less than the profit. Thus, the seller's profit on the sale is more than the cash he receives for the property.
45. Temporary Treas. Reg. § 15a.453-1(b)(3)(i), 1981-10 I.R.B. 14.

which represents amounts received by the seller.[46] The excess is similarly treated as an actual cash payment to the seller. The result is the technical definition of contract price: sale price minus mortgages assumed or taken subject to which are within the seller's basis. This treatment ensures that the gross profit percentage will never be greater than 100% and that all mortgages in excess of basis which are assumed or taken subject to will represent taxable income in the year of sale.

Application of these rules to situations in which a purchaser assumes or takes property subject to a mortgage has the following effects. The contract price is first adjusted downward by the amount of the mortgage, with the result that a larger percentage of each payment is treated as income and a lesser percentage as return of basis. If the assumed mortgage is equal to the property's basis, the gross profit percentage is 100 and the seller recoups his basis in the property in the year of sale by the purchaser's assumption of responsibility for the mortgage debt. All additional payments received in the year of sale and subsequent years are taxed as income to the seller.[47] If the assumed mortgage is in excess of basis, the seller is relieved of the mortgage debt in the year in which the purchaser assumes the mortgage, and the excess of the assumed debt over basis is gain recognized by the seller in that year.[48] Additional payments are also taxed as income to the seller.[49]

The key to the utility of the wraparound transaction is that the purchaser *does not* assume or take the property subject to the first mortgage.[50] The purchaser pays the seller the full value of the property and makes no payments to the seller's mortgagee;[51] therefore, he does not relieve the seller of the original mortgage debt on the property. As a result, the contract price equals the selling price,[52] and there is no reduction of the contract price for the seller's debt relief from mortgages assumed or taken subject to by the purchaser. More importantly, there will be no gain treated as if received in the year of sale. This results because there is no excess of mortgage over basis problem since the purchaser does not relieve the seller of his debt to the senior mortgagee. An exam-

46. *Id.* § 15a.453-1(b)(2)(iii), 1981-10 I.R.B. 13.
47. For an example of a transaction involving an assumed mortgage equal to the basis of the property sold, see *supra* note 23.
48. *See supra* notes 39-46 and accompanying text.
49. Whenever the gross profit percentage reaches 100%, all payments received by the seller are income because by definition the seller has already recouped the basis of the property.
50. *See, e.g.*, Estate of Lamberth v. Commissioner, 31 T.C. 302, 315 (1958).
51. *See, e.g.*, Stonecrest Corp. v. Commissioner, 24 T.C. 659, 668 (1955).
52. *See supra* notes 39-46 and accompanying text.

ple will illustrate the different tax results for the two types of transactions.

Assume A sells B property for $1,000,000 which has a basis of $200,000 and is mortgaged to the extent of $500,000. In return for the property, A receives a cash payment of $100,000 and a four-year installment promissory note bearing adequate interest for $400,000. B takes subject to the mortgage and pays the original mortgagee directly. A's taxable income for the year of sale is calculated as follows. His gross profit is $800,000 and the contract price is $800,000 ($1,000,000 selling price minus $200,000 mortgage within basis). The amount received by A in the year of sale is $400,000 ($100,000 cash + $300,000 mortgage in excess of basis). The gross profit percentage is 100% ($800,000 gross profit divided by $800,000 contract price). A's taxable income from the sale is $400,000 in the year of sale and $100,000 per year during the four-year discharge of the note.

If the above transaction were financed through a valid wraparound mortgage, where A remained primarily liable on the first mortgage, the tax result would be as follows. The gross profit would remain $800,000. The contract price, however, would be $1,000,000 because B would not assume or take subject to the mortgage. B would remit $200,000 to A in the year of sale and give A a promissory note for $800,000 to be paid $200,000 per year for four years. A would pay off the first mortgage at the rate of $100,000 per year. The gross profit percentage would equal eighty percent ($800,000 gross profit divided by $1,000,000 contract price) and the amount received in the year of sale would be $200,000. A's taxable income from the sale would be $160,000 in the year of sale and $160,000 per year during the four-year discharge of the note.

The wraparound mortgage financing in the above example would defer $240,000 of income from the year of sale and spread it evenly over the remaining term of the second mortgage and promissory note. This result is obtained because the excess of the first mortgage over the basis in the property is not treated as a payment received in the year of sale.

The essence of the wraparound transaction is that the original mortgagor remains primarily liable on the first mortgage,[53] the purchaser of the property does not assume or take subject to the mortgage,[54] and all payments are remitted to the seller and reported as payments received on the wraparound indebtedness.[55] This justifies the delay in recognizing income and spreads the seller's gain

53. *See infra* notes 103-18 and accompanying text.

54. *See infra* notes 67-87 and accompanying text.

55. *See infra* notes 119-29 and accompanying text.

over the payments he receives from the sale of the property in accord with the ultimate purpose of section 453.

In the temporary section 453 regulations, the Internal Revenue Service has taken the position that any purported wraparound mortgage transaction will be ignored, regardless of whether the seller remains primarily liable thereon, and the purchaser will be deemed to have taken the property subject to the mortgage.[56] This will effectively deny the seller the benefits of the wraparound mortgage.

Prior to the promulgation of the regulations, the Tax Court had, through a series of opinions, defined the parameters of a valid wraparound transaction.[57] Although the requirements were stringent, taxpayers could qualify for wraparound mortgage treatment if economically real transactions were involved.[58] The Tax Court's position with regard to wraparound transactions seems to comport with economic reality and the purpose of installment sales reporting.[59] In contrast, the temporary regulations appear to represent a draconian attitude that because in the large majority of transactions the purchaser will in fact assume or take the property subject to the mortgage, all transactions involving the sale of mortgaged property should be so treated, regardless of economic reality.

The remainder of this section of the Comment will outline the parameters of a valid wraparound mortgage as defined by the Tax Court and compare them to the apparent position of the Service.

B. Parameters of a Valid Wraparound Mortgage and the Purpose of Section 453

Since the inception of the wraparound mortgage cases,[60] the Tax Court has attempted to define the indicia of a valid wrapped mortgage by examining the obligations created between the origi-

56. Temporary Treas. Reg. § 15a.453-1(b)(3)(ii), 1981-10 I.R.B. 14-15.

57. Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975), *aff'd*, 613 F.2d 518 (5th Cir. 1980); Hutchison v. Commissioner, 42 T.C.M. 1089 (1981); Goodman v. Commissioner, 74 T.C. 684 (1980); Voight v. Commissioner, 68 T.C. 99 (1977); Waldrep v. Commissioner, 52 T.C. 640 (1969), *aff'd per curiam*, 428 F.2d 1216 (5th Cir. 1970); United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963); Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958); Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955).

58. *See infra* notes 67-95 and accompanying text.

59. The purpose of § 453 is to spread the gain from a sale of property over the period during which the installment payments of the sale price are received. Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 503 (1948); SENATE REPORT, *supra* note 14, at 7-8, 1980 U.S. CODE CONG. & AD. NEWS at 4701-03.

60. Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955), is considered to be the seminal case in this area.

nal mortgagor, his purchaser, and the mortgagee.[61] The Tax Court described this approach as follows:

> While in a sense every sale of mortgaged property is subject to a mortgage since the property remains liable to have the mortgage debt satisfied from it, we think the expression [assuming or taking property subject to a mortgage] was used in the regulation in its customary meaning, to define the obligations of the parties to a sale of property with respect to the mortgage debt.[62]

This focus on the parties' obligations to one another strikes at the core of the purpose of section 453, which is to spread a seller's gain over the actual payments he receives for the property.[63] Although the mortgagee's overriding security in the property is always present, the "secondary" personal obligations of the parties define the flow of cash from the purchaser to the original mortgagor, and ultimately to the mortgagee. Since section 453 is an income-timing device,[64] which was designed to operate on the basis of the flow of cash payments to a seller, this "obligations" analysis comports with the purposes of section 453.

Assume the typical wraparound financing situation in which three parties are involved—the seller of mortgaged property, the purchaser, and the mortgagee. The seller is the pivotal character in the transaction and is involved in agreements with both the purchaser and the senior mortgagee. The purchaser agrees to make payments to the seller on the second mortgage. From the purchaser's perspective, the seller is the sole mortgagee of the property, and the purchaser pays the seller for the full value of the property. Nevertheless, the senior mortgagee retains the first mortgage on the property. To protect his quiet possession of the property, the purchaser will require the seller to agree to continue to pay the senior mortgagee, even though the seller no longer possesses the property. The seller will remain primarily responsible to the senior mortgagee for the discharge of the first mortgage on the property. In one sense then, the seller will agree to route payments from the ultimate purchaser to the senior mortgagee.

Predictably, the Internal Revenue Service has attacked this

61. *See* Levinton, *Use of wrap-around mortgages can expand installment sales despite IRS opposition*, 51 J. TAX'N 166 (1979).
62. Stonecrest Corp. v. Commissioner, 24 T.C. 659, 668 (1955).
63. *See, e.g.*, Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948); Prendergast v. Commissioner, 22 B.T.A. 1259, 1262 (1931); SENATE REPORT, *supra* note 14, at 7, 1980 U.S. CODE CONG. & AD. NEWS at 4701-02. Since at least 1928, the Tax Court has focused primarily on an evaluation of the obligations and payments made among the parties in analyzing transactions involving mortgage assumptions. *See* Pacheco Creek Orchard Co. v. Commissioner, 12 B.T.A. 1358 (1928).
64. Section 453 does not affect the amount of gain realized on a transaction but rather the time at which it is recognized. *See* Ginsburg, *supra* note 9, at 475.

transaction.[65] It has asserted that the purchaser has relieved the seller of the senior mortgage debt and, if the debt is in excess of basis, that the excess is income which must be recognized by the seller in the year of sale. Although the old regulations were neutral on the subject, the temporary regulations adopt the position that all mortgages are assumed when encumbered property is sold.[66]

The Tax Court began delineating its position regarding wraparound mortgage financing by allowing its benefits to a seller of property who could demonstrate a binding obligation which left him primarily liable[67] to his senior mortgagee and which required that payments on the first mortgage would flow from the purchaser through the seller to the mortgagee.[68] The taxpayer-seller had to demonstrate that he was not relieved of the mortgage debt in the year of sale.[69] *Stonecrest Corp. v. Commissioner*[70] was the initial case in which the distinctive features of wraparound-type[71] financ-

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65. For a list of the major cases in which the Service has litigated the validity of wraparound financing, see *supra* note 57.
66. *Compare* Treas. Reg. § 1.453-4(c) (1958) (wraparound mortgage transactions are not explicitly addressed) *with* Temporary Treas. Reg. § 15a.453-1(b)(3)(ii), 1981-10 I.R.B. 14-15 (purchaser is always deemed to have assumed the mortgage or to have taken the property subject to it).
67. Stonecrest Corp. v. Commissioner, 24 T.C. 659, 663 (1955).
68. *Id.* at 667-68.
69. *Id.* at 669.
70. 24 T.C. 659 (1955). The Stonecrest Corporation was in the business of building homes and obtained initial financing by mortgaging each home and its accompanying lot. When a home was sold, a two-part payment schedule was adopted. Under the first part, the purchaser's payments equaled Stonecrest's payments on the first mortgage and an additional amount which returned Stonecrest's equity in the property. Under the second-part, payments began when Stonecrest's equity had been redeemed and equaled the amount of payments made on the first mortgage. Purchasers could pay the remaining balance on the contract after a period which ranged from five to eight years. Title to the property passed only upon payment of the total selling price. *Id.* at 662.
71. The *Stonecrest* case, as well as the majority of the cases cited in note 57 *supra*, involved a contract for deed, or an installment land contract, rather than a wraparound mortgage. For tax purposes, the two should be treated identically because they are simply two different forms of a security device. The obligations of the parties *inter se* regarding payments on the mortgage are the same in either case. Levinton, *supra* note 61, at 169. The Tax Court recently declined to decide whether wraparound mortgages should be treated the same for tax purposes as installment land contracts. Goodman v. Commissioner, 74 T.C. 684, 712 & n.16 (1980). However, the resolution of that issue was not necessary for its decision in *Goodman*. In prior cases, the Tax Court held that the location of legal title was not relevant to the issue of whether a mortgage had been assumed. Voight v. Commissioner, 68 T.C. 99 (1977); Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958). Location of legal title is one difference between a mortgage and an installment land contract transaction. *See infra* note 90.

ing were recognized. In *Stonecrest*, the court determined that the issues of the availability of installment reporting and the treatment of the excess of mortgage over basis as a payment received in the year of sale depended upon the meaning of taking subject to or assuming a mortgage.[72] In seeking these meanings, the court was aware that its ultimate judicial goal was to apply section 453 consistently with its purpose.[73]

The court first found that a mortgage was assumed when the purchaser paid the seller for its redemption interest and promised the seller to pay off the mortgage debt.[74] Thus, in effect, the purchaser became primarily liable to the senior mortgagee, since the mortgagee could ordinarily enforce the purchaser's promise to the seller[75] on a third-party beneficiary theory[76] or subrogation claim.[77] The court then identified three factors which weighed against finding that the purchaser had assumed the mortgage. First, the purchaser made all payments to the seller, leaving the seller to pay the senior debt service.[78] Second, there was no syn-

72. 24 T.C. at 666.
73. *Id.* at 668. The court noted that the Commissioner's view would apply the "assumed" or "taken subject to" language to *all* sales of mortgaged property, effectively negating the utility of the terms in the regulation. *Id.* The presence of the terms in the regulation imply that some sales of mortgaged property are not subject to the mortgage.
74. *Id.* at 666 (citing 5 Tiffany, THE LAW OF REAL PROPERTY, §§ 1435, 1436 (3d ed. 1939); 4 AMERICAN LAW OF PROPERTY §§ 16.125, 16.127, 16.128-.132 (A.J. Casner ed. 1952)).
75. 24 T.C. at 666.
76. *See, e.g.*, Evans v. Sperry, 12 F.2d 438 (D.C. Cir. 1926); Becker v. Nelson, 164 Minn. 367, 205 N.W. 262 (1925); G. OSBORNE, G. NELSON, & D. WHITMAN, *supra* note 29, at 269-70. This theory is based on the premise that a contract between the purchaser and the seller can create an independent enforceable right in the mortgagee because the assumption contract was intended to benefit the mortgagee. *Id.*
77. *See, e.g.*, Keller v. Ashford, 133 U.S. 610 (1890). Unlike a claim under a third-party beneficiary theory, a subrogation claim is a derivative cause of action. The purchaser of the property would promise to indemnify the seller if he were forced to pay the mortgagee because of the purchaser's default on his principal obligation to pay the mortgagee the debt service on the assumed mortgage. The mortgagee would be subrogated to the rights, or stand in the shoes, of the seller and thus could sue the purchaser on the seller's indemnity claim against the purchaser. *See* G. OSBORNE, G. NELSON, & D. WHITMAN, *supra* note 29, at 271-73.
78. 24 T.C. at 662-63. In *Stonecrest*, title did not pass from the seller to the purchaser until the purchaser either paid off *both* the first and second mortgages or formally assumed the senior mortgage and paid the seller his equity (the value of the second mortgage). Apparently, the court was not overly concerned with the formal passage of title. Instead the court focused on who was primarily liable on the first mortgage debt. The court stated: "Even if title had passed before complete performance . . . petitioner would have remained primarily liable to the bank . . . ." *Id.* at 662.

chronization between the seller's collection of payments from the purchaser and its payment of the senior debt to the mortgagee.[79] Finally, the mortgagee continued to carry the seller as the debtor on its records, indicating that that seller bore the primary responsibility for payment of the debt.[80]

The court found that property was taken subject to a mortgage where there was no valid personal primary obligation on either the purchaser or the seller-mortgagor to pay the mortgage debt.[81] However, because the purchaser would have paid the seller for his equity in the property, i.e., the redemption interest, there would be an implicit understanding that the purchaser would pay the mortgage debt to avoid foreclosure on the property which he pos-

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79. *Id.* at 663. The lack of synchronization made it less likely that Stonecrest was the agent of the purchaser and making payments on its behalf.

80. Stonecrest in fact had an option, which was not exercised, to require a complete release rather than a mere assumption of its liability on the mortgage before title passed. *Id.* at 667. A mortgagor remains secondarily liable on an assumed mortgage but is absolved of liability if a release is executed. Under prior law, a total release from liability was treated as a payment in the year of sale, even if the mortgagor was released from a mortgage debt *within* his basis. Taxpayers who had been released from liability on a mortgage which was within basis had attempted to argue that the release was the equivalent of an assumption, and thus they were not required to include the amount of the release as income because it was within basis. However, if the taxpayer did not remain secondarily liable, the Tax Court found that he had been released, and the amount of the released mortgage was considered as a payment received in the year of sale. *See* Muller v. Commissioner, 38 T.C.M. 719 (1979); Maddox v. Commissioner, 69 T.C. 854 (1978). *See also* Rev. Rul. 71-515, 1971-2 C.B. 222 (when the mortgagee is the purchaser, there is a cancellation of the debt, or a merger of the fee and the mortgage, and the cancellation is treated as a payment in the year of sale, by analogy to the release). The Installment Sales Revision Act temporary regulations change this result. A novation (the formal release of a party with the concurrent replacement of that party with another) or a release of a mortgagor is treated the same as an assumption. If the mortgage debt released is within basis, no amount is treated as a payment received in the year of sale. Temporary Treas. Reg. § 15.a-453-1(b)(3)(i), 1981-10 I.R.B. 14. Novation of a mortgage *within basis* results in an economic benefit to the taxpayer equal to the amount of debt relief, but since he has already paid tax on this amount, it would be inappropriate to spread his gain over the debt-relief payment.

81. 24 T.C. at 666. The seller remains liable to the mortgagee and although the agreement between the mortgagor-seller and the purchaser may stipulate that the land will serve as the *primary* source from which payment will be made to the mortgagee through a potential foreclosure sale, the mortgagee may not, in some jurisdictions, be forced to foreclose on the property to collect the debt. He may proceed against the mortgagor-seller notwithstanding the seller-purchaser agreement to the contrary. The *seller*, however, will be able to cause the purchaser to exhaust the land in payment of the debt, or if he pays the debt himself, he can recover the amount from the purchaser through a foreclosure sale. *See* 4 AMERICAN LAW OF PROPERTY, *supra* note 34, § 16.127.

sessed[82] and to protect his cash outlay.[83]

In *Stonecrest*, the court determined that the parties' agreement expressly provided that the seller would make payments on the mortgage debt until the conveyance of the property, and that the agreement was enforceable between the parties.[84] Additionally, the court noted that the purchaser clearly paid the seller the full sale price, rather than its lesser redemption interest, which indicated that the property was not taken subject to the mortgage.[85]

Finding that the purchaser had not assumed or taken subject to the mortgage, the court held that the amount of the mortgage on the property which exceeded the seller's basis should not be treated as a payment received in the year of sale.[86] Thus the court rejected the Commissioner's claim that more taxable income should have been recognized in the year of sale.[87]

It should be noted that the *Stonecrest* case, as well as several others in this area,[88] involved the use of an installment land contract, also called a contract for deed, as the security device. This instrument is analogous to the wraparound purchase money mortgage[89] and, for tax purposes, is its equivalent.[90] The obligations between the parties which define the flow of money from pur-

82. 24 T.C. at 666.
83. *Id.* at 667.
84. *Id.*
85. *Id.* at 668. This fact, together with the lack of synchronization of payments and the seller's primary liability to the mortgagee, made the sale economically real.
86. *Id.* at 669.
87. *Id.*
88. *See supra* note 57.
89. *See* J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS §§ 3.58-.81 (1970). Hetland observed: "Though complete equation still seems a few years away, when the land contract is absorbed into the security system . . . , it will make little difference that technically it is a contract; practically and remedially it will be a purchase-money mortgage." *Id.* § 3.81. *See generally* J. HETLAND, SECURED REAL ESTATE TRANSACTIONS (1974).
90. The most significant differences between a purchase money mortgage wrapped around an existing mortgage and an installment land contract may be the remedies available against the defaulting purchaser. Comment, *Installment Land Contracts: Remedies in Nebraska*, 60 NEB. L. REV. 750, 755 (1981). In a lien state, title to the property passes to the purchaser when a mortgage is used to secure the purchase price. In contrast, title remains with the seller when property is sold pursuant to a land contract. However, the remedies available to the seller to enforce his security are governed by the underlying equitable interests in the property in both the mortgage and land contract situations. *Id.* at 753. Section 453 is concerned with the manner in which payments are made between the parties. These payment procedures can be defined with equal efficacy in either the mortgage or the installment land contract.

chaser to seller to mortgagee are the same in each type of transaction.

There are numerous variations of the wraparound-type financing situation involved in *Stonecrest*. Subsequent Tax Court opinions reveal which of these variations are permissible and which will result in losing the benefits of wraparound financing.

In *United Pacific Corp. v. Commissioner*,[91] the court found that the purchaser's assumption of the senior mortgage in the sixth year after the sale of the property did not preclude wraparound treatment for the seller during the five-year period in which the seller was primarily liable to the mortgagee.[92] The agreement between the purchaser and the seller contemplated the formal assumption of the mortgage in the sixth year.[93] Accordingly, the court allowed the seller to recognize gain ratably as payments were actually received over the five-year interim and to recognize the "balloon" payment in the sixth year when the mortgage was formally assumed.[94]

The court explained that its conclusion was shaped by a desire to further the purpose of section 453:

> [P]etitioner reported the full profit of $991,240 on the sale over the 5-year

91. 39 T.C. 721 (1963). *United Pacific* involved the sale of a commercial building pursuant to a contract for deed in which the purchaser made payments to the seller over a five-year period. In the sixth year, the purchaser paid United Pacific its remaining equity interest, took title to the property, and assumed the remaining mortgage. United Pacific was carried as the primary obligor on the mortgagee's records until the purchaser assumed the mortgage. The payment schedule and other relevant figures in the transaction were: gross sale price—$1,706,000; net sale price—$1,703,722.75; basis of property—$712,482.75; gain—$991,240. The gross profit percentage was $991,240 divided by $1,706,000 (the sale price was not reduced by any mortgage because of the wraparound feature) or 58%. United Pacific reported income as follows (rounded):

	(A) Amount paid under contract	(B) Profit (58% of Col. (A))
1955	$ 206,000	$119,692
1956	79,835	46,386
1957	45,269	26,302
1958	67,919	39,463
1959	91,341	53,072
1960	1,215,634	706,322

The excess of mortgage over basis was $537,517.25. The Commissioner sought to have this excess treated as a payment in 1955, making the total payments $743,517, compared to the $206,000 United Pacific reported. As a result, the taxpayer would have been disqualified from using installment reporting because of the 30% rule.

The final payment of $1,215,634 represents the redemption of the seller's equity and the assumption of the mortgage by the purchaser.

92. 39 T.C. at 723-24.

93. *Id.* at 724.

94. *Id.* at 728. *See supra* note 91 for the payment schedule used by the parties.

> period. . . . We cannot see how the interpretation given to the regulation in the *Stonecrest* case fails to give effect to the purpose of section 453, which is to enable a seller to distribute the profit on an installment sale over the years in which he actually received payments of the purchase price. In fact, respondent's interpretation would appear to be contrary to the statutory purpose, since in this case it would mean that petitioner's entire profit of $991,240 . . . would be taxable in the year of sale, when petitioner received a cash payment of $206,000 . . . .[95]

The importance of the agreement between the parties can be illustrated by comparing the *United Pacific* case with *Estate of Lamberth v. Commissioner*.[96] In *Lamberth*, the parties did not provide for a formal assumption of the mortgage by the purchaser.[97] However, the seller's equity in the property was to be completely paid off during the initial ten years of a fourteen-year installment contract, and title to the property was to pass to the purchaser in the tenth year.[98] Nevertheless, the seller's mortgage payments to the senior mortgagee were to run for fourteen years, four years longer than the land contract. With the land contract terminated and title in his possession, the purchaser would pay, on behalf of the seller, the remaining senior mortgage balance directly to the mortgagee in the tenth year to protect his property.[99]

For tax purposes, the agreement between the parties was interpreted as anticipating, at the time of sale,[100] that the purchaser would take the property subject to the mortgage balance.[101] Thus, the selling price was reduced by the amount of the mortgage balance remaining after ten years to arrive at the contract price. This increased the gross profit percentage and spread the gain represented by the mortgage balance over the payments that the seller would actually receive during the ten year contract term.[102] Presumably, if the parties had provided for a formal assumption of the mortgage in the tenth year, the seller could have deferred recognition of the gain from the assumption until the tenth year under the rationale of the *United Pacific* case. Therefore, providing for a for-

95. 39 T.C. at 727-28.
96. 31 T.C. 302 (1958).
97. *Id.* at 316.
98. *Id.*
99. *Id.* This was a presumption by the court based on all the evidence before it.
100. The location of title was not treated as a relevant consideration in this case. The purchaser was considered to have assumed or taken the property subject to the remaining mortgage balance *as of the time of sale*. If the equivalent of a mortgage assumption may be found without the passing of title, a corollary would seem to be that the passing of title cannot be the *sine qua non* of an assumption or taking subject to a mortgage as the Service is apparently now contending. *See* Priv. Let. Rul. 7814011 (Dec. 29, 1977); Priv. Let. Rul. 7814010 (Dec. 23, 1977); Levinton, *supra* note 61, at 170.
101. 31 T.C. at 316.
102. *Id.* at 316-17.

mal assumption of a mortgage may enable deferred recognition of income that would otherwise be recognized earlier.

As in other tax areas, the courts look to the substance of a transaction, not its form, in determining whether it qualifies for section 453 treatment.[103] When it appears that the purchaser has become a party to the mortgage contract between the seller-mortgagor and the mortgagee so that the mortgagee can directly enforce the obligation against the purchaser, an assumption of the mortgage will be found, regardless of what the parties expressly provided in their agreement.[104] In such a situation, the seller-mortgagor is no longer the nexus between the purchaser and the mortgagee since the purchaser will probably seek to satisfy the mortgage debt by directly paying the mortgagee to avoid the risk of the seller's mishandling of the funds. The purchaser's direct payment of the mortgage debt will vitiate the wraparound transaction by relieving the mortgagor of his mortgage debt in the year of the sale. Specifically, the purchaser's assumption of the primary responsibility on the mortgage debt relieves the seller of a personal liability, which justifies treating the excess of the mortgage over basis as a payment received in the year of sale.[105]

There are several other situations in which the benefits of financing a property sale with a wraparound mortgage will be lost because of the application of the substance-over-form analysis. For example, in *Voight v. Commissioner*,[106] the purchaser and the senior mortgagee were anxious to assure that the purchaser's payments which were targeted to pay off the senior mortgage actually found their way through the seller's hands to the mortgagee.[107] To assuage the parties' anxieties, the installment contract contained an option which provided that the purchaser could pay the mortgagee directly and, that in such event, the payments were to be deemed made on the contract on the seller's behalf.[108] Additionally, the mortgagee required the purchaser and the seller to jointly

103. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Hindes v. United States, 326 F.2d 150, 151 (5th Cir. 1964).

104. *See, e.g.*, Republic Petroleum Corp. v. United States, 397 F. Supp. 900, 910 (E.D. La. 1975), *aff'd*, 613 F.2d 518, 524 (5th Cir. 1980); Voight v. Commissioner, 68 T.C. 99, 113-14 (1977); Waldrep v. Commissioner, 52 T.C. 640, 645-46 (1969). This substantive analysis has been viewed as being too definitional, and therefore superficial. Comment, *supra* note 35, at 1552-57. However, the Tax Court has attempted to determine the significance of assuming a mortgage or taking subject to it by looking at the substance of the transaction and the purpose of section 453.

105. The cases dealing with wraparound mortgages equate debt relief with direct payment between purchaser and mortgagee. *See supra* note 57.

106. 68 T.C. 99 (1977).

107. *Id.* at 113.

108. *Id.* at 102.

execute a mortgage loan amendment in which the purchaser absolutely guaranteed payment of the first mortgage.[109]

The Tax Court found that the guarantee was tantamount to an assumption because the mortgagee could enforce the loan amendment by directly suing the purchaser, a party to the amendment, without first attempting to collect from the seller.[110] Although the seller was jointly liable with the purchaser, the seller's loss of status as the sole primary obligor on the mortgage was sufficient for the court to find an assumption.[111]

In addition, the court found that the parties intended that the purchaser make payments to the senior mortgagee, thereby discharging the seller's debt.[112] The intention was manifested by: (1) the absolute "direct liability" guarantee, (2) the option allowing such direct payment, and (3) the actual course of dealing between the parties under which the purchaser paid the mortgagee.[113]

Another variation which will not withstand the court's calculus for analyzing wraparound-type transactions occurs when the purchaser accepts personal liability on a new mortgage encumbering property previously mortgaged by the seller.[114] Taxpayers would most likely attempt this type of financing when a real estate subdivision is involved. For example, a large tract of land may be financed and, after it appreciates in value, subdivided for resale. Assume that the mortgagee agrees to release a parcel of land from its encumbrance and shift the amount released to the encumbrance on the remaining appreciated land owned by the seller. The purchaser of the parcel of property then gives the seller a note and a mortgage for the value of the seller's equity in the property.[115] The purchaser also gives the mortgagee a note and a new mortgage equivalent to the one released.[116]

This transaction will be treated as an assumption of the original mortgage by the purchaser despite the technical release and creation of a new mortgage.[117] It will not avail the seller to argue that he has not been released from the debt because the released amount was added to the encumbrance on the rest of the land he owns. The purchaser will be deemed the primary obligor on the

109. *Id.* at 103.
110. *Id.* at 113 (citing Swift & Co. v. Geraghty, 199 Wis. 329, 226 N.W. 381 (1929); United States v. Klebe Tool & Die Co., 5 Wis. 2d 392, 92 N.W.2d 868 (1958)).
111. 68 T.C. at 113 n.7.
112. *Id.* at 113.
113. *Id.*
114. *See* Waldrep v. Commissioner, 52 T.C. 640 (1969).
115. *See id.* at 642. The situation described in the text tracks the facts of *Waldrep*.
116. *Id.*
117. *Id.* at 646.

portion of the senior mortgage which was released, and, if the debt is in excess of the basis of the parcel of property, the seller will recognize gain on the creation of the new mortgage.[118]

An attractive variation of a wraparound financing transaction might be to provide for a trust or an agent to collect proceeds from the purchaser and remit the appropriate portion of each payment to the seller and the senior mortgagee.[119] This structure would provide a measure of security to all parties while not straying too far from the fundamental character of a wraparound transaction. However, the Tax Court's decision in *Goodman v. Commissioner*[120] has precluded the use of a trust or an agent for collection and distribution of payments in a wraparound transaction, at least in some circumstances.

In *Goodman*, the parties chose a bank to act as an agent for the collection of the purchaser's payments.[121] Ostensibly, the bank was only the seller's agent and was to collect payments on its behalf. However, the bank was contractually bound to the purchaser to route the debt service to the senior mortgagee. The court found that the bank was a collection agent for both the seller and the mortgagee and a distribution agent for the purchaser.[122] As a result of the contractual collection and distribution structure, the purchaser's payments did not actually pass into and out of the seller's general funds.[123] The seller's independent obligation to the mortgagee to pay debt service was rendered meaningless by the agent's obligation to the purchaser to route the payments to the mortgagee without first allowing them to come under the seller's control.[124] From the day the collecting bank became obli-

118. *Id.*
119. *See* Comment, *supra* note 35, at 1552.
120. 74 T.C. 684 (1980). The seller in *Goodman* took a purchase money wraparound mortgage to secure the installment note. *Id.* at 692.
121. *Id.* at 714. In *Goodman*, a partnership sold property to a trust, whose beneficiaries were the partners' children. The property was mortgaged in excess of basis, and the trust sold the property to a third party. The partnership ostensibly remained liable on the mortgage encumbering the property, and the third party was to pay the trust, which in turn would remit the payments to the partnership for final transfer to the mortgagee. However, a clause in the note given in payment by the third party set forth a collection agreement whereby a banking institution would act as agent for the trust and the partnership. The bank was to collect the installments made by the purchaser and route the appropriate amounts to the mortgagee and the trust. The trust would then pay the part of each payment owed the partnership and retain the remainder for investment. Significantly, the bank was obligated to the purchaser by contract to pay the required portion of the total payment to the mortgagee.
122. *Id.*
123. *Id.* at 713.
124. *See supra* notes 121-22 and accompanying text.

gated to collect the purchaser's payments and route them to the mortgagee, the seller was relieved of the primary duty to pay the mortgagee.[125] Similarly, the purchaser was relieved of the risk of relying on the seller to make the required mortgage payments.

The *Goodman* court did not find that the purchaser had assumed the mortgage because there was no agreement between the mortgagee and the purchaser, nor was there an option allowing direct payment from the purchaser to the mortgagee.[126] However, the court noted that under the collection arrangement, only the redemption interest was actually being paid to the seller. Payment of only the redemption interest to a seller of property is a primary indicator that the purchaser has taken the property subject to a mortgage, and this was the ultimate finding of the court.[127] As with a mortgage assumption, selling property subject to a mortgage relieves the mortgagor-seller of the mortgage debt. The purchaser's taking subject to the mortgage and the mortgagor's debt relief were illustrated in *Goodman* by the purchaser's use of the bank as a collecting agent to ensure that its payments were made to the mortgagee.[128] Since the mortgage debt was treated as relieved in the year that the property was transferred to the purchaser, the amount of the mortgage in excess of basis was treated as an amount received by the seller in that year.[129]

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125. *See* Comment, *supra* note 35, at 1552, which the court cited in its analysis of the transaction. 74 T.C. at 714.
126. 74 T.C. at 713.
127. *Id.* at 714. It should be apparent that the assumption of a mortgage or taking property subject to a mortgage is only detrimental when the mortgage is in excess of basis. When the mortgage is within basis, taxpayers have an incentive to attempt to mortgage their property in anticipation of sale and have the buyer take subject to the mortgage. This would allow a realization of cash from the property while deferring recognition of gain until payments were received on the installment obligation. Borrowing on property in anticipation of its sale for this purpose will result in sham treatment of the mortgage debt, and the assumption will be treated as an amount received in the year of sale. If the borrowing is bona fide and not in anticipation of sale, deferral of recognition is allowed. Turner v. Commissioner, T.C.M. (P-H) ¶ 74,264 (1974); Denco Lumber Co. v. Commissioner, 39 T.C. 8 (1962).
128. 74 T.C. at 713-14.
129. *Id.* at 714. Some earlier cases indicated that the purchaser's payment of liabilities other than a mortgage on the property in the year of sale would be treated as a payment received in the year of sale *even if* the amounts paid were within the taxpayer's basis. Thus a distinction was drawn between mortgage assumption and discharge of other liabilities generated in the business in which the property was used. Wagegro Corp. v. Commissioner, 38 B.T.A. 1225 (1938); Batcheller v. Commissioner, 19 B.T.A. 1050 (1930). In later cases, the courts have found that payment of liabilities generated in the course of a business associated with the property should be treated the same as an assumption of a mortgage, i.e., no payment is deemed received in the year of sale unless the amount of liability assumed exceeds the seller's basis

It is thus apparent that wraparound treatment will be precluded in a transaction where the trust or agent is contractually bound to collect and distribute the purchaser's payments and the payments do not pass into the seller's control and become commingled with his general funds before payment is made to the mortgagee. Since the only apparent purpose of using the trust or agent is to avoid the risk of the seller's mishandling of the purchaser's funds, the *Goodman* case removes the incentive for using either device in a wraparound transaction.

To the extent that any principles can be distilled from the Tax Court's treatment of wraparound financing transactions, it would appear that a valid wraparound transaction must leave the purchaser and the senior mortgagee isolated from each other. The purchaser must not become primarily liable on the seller's debt by way of any agreement or guarantee with the mortgagee, and the mortgage payments must be made only through the seller to the mortgagee.[130] The sales contract should not provide the purchaser with an option to directly pay the mortgagee.[131] No trust or agency collection system should be attempted, and the purchaser's payments should come under the seller's control before they are remitted to the mortgagee.[132] Although the seller may serve as a conduit for payments from the purchaser to the mortgagee, economic reality is demonstrated by a lack of synchronization[133] between the purchaser's payments to the seller and the seller's payments to the mortgagee. A lack of synchronization allows time for the payments to commingle with the seller's funds and be subject to his full control. This gives substance to the seller's independent obligation to the mortgagee by placing a risk on the purchaser that he may be forced to vindicate his right to have the seller pay the mortgage by suing the seller on the contract between them.

In addition to the previously discussed variations of the wraparound transaction which should be avoided by taxpayers, mention should be made of two peripheral matters. First, the taxpayer should avoid using a controlled entity to act as the purchaser of property from himself as seller of the property.[134] In such a case,

in the property. Irwin v. Commissioner, 390 F.2d 91 (5th Cir. 1968); Marshall v. United States, 241 F. Supp. 30 (S.D. Cal. 1964), *aff'd*, 357 F.2d 294 (9th Cir. 1966). The temporary regulations adopt the position of the later cases. *See* Temporary Treas. Reg. § 15a.453-1(b)(2)(iv), 1981-10 I.R.B. 13-14.

130. *See supra* notes 96-113 and accompanying text.

131. *See supra* notes 106-13 and accompanying text.

132. *See supra* notes 119-29 and accompanying text.

133. *See supra* notes 78-80 and accompanying text.

134. *See* Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975), *aff'd*, 613 F.2d 518 (5th Cir. 1980). In *Republic*, the taxpayer sold prop-

the taxpayer's control of the purchaser-entity makes it possible for him to cause the purchaser to assume the mortgage at any convenient time.[135] Maintaining a position on both sides of the transaction creates the potential for abuse, and, as a result, the transaction will be deemed to lack economic reality and will be refused recognition as a valid wraparound transaction.[136]

Second, when a taxpayer initially has achieved a valid wraparound transaction, he should be wary of any modifications to the agreement which could detrimentally affect the tax consequences. For example, in any case where the seller receives a premature redemption of his equity in the property, it will appear as if he can walk away from the transaction and leave the purchaser to pay the mortgagee.[137] This result becomes especially likely when the

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erty to a corporation of which he was the majority shareholder and the ultimate decision-maker. The original sale agreement provided that Republic would assume the mortgage, but in a subsequent letter, in effect from the taxpayer, acting for Republic, to himself, the corporation manifested its intention to give the taxpayer a note for the full purchase price, including the value of the mortgage. The taxpayer was to remit the necessary mortgage payments to the mortgagee. Republic's corporate records indicated that payments to the taxpayer were to *reimburse him* for discharging the *corporation's* loan, and that Republic had the option to accelerate full payment on the note at any time. Accelerating payment on the note would require the corporation to assume the mortgage and, since the taxpayer controlled the corporation, he was in effect able to cause, at will, the corporation's assumption of the mortgage. Not only did the corporation merely pass payment to the mortgagee through its principal shareholder, but the ability of the taxpayer-principal shareholder to accelerate payment on the note and force assumption of the mortgage indicated that he was able to manipulate the transaction for his own tax benefit. Regardless of the nominal description of the transaction in the subsequent sham letter, the taxpayer was clearly acting in a corporate capacity when payments were made to the mortgagee. The court would not allow this disregard for economic reality and found that the corporation had in fact assumed the mortgage in the year of sale. 397 F. Supp. at 910-11.

135. *See* Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975), *aff'd*, 613 F.2d 518, 520 n.2 (5th Cir. 1980). The taxpayer, through his control of Republic could cause the corporation to prepay the note at any time. In effect he held a demand note in his individual capacity and the corporation had to stand ready to assume the mortgage. The taxpayer was found to have constructively received an assumption of the mortgage in the year of sale. 613 F.2d at 522-23.

136. 613 F.2d at 524.

137. *See* Hutchison v. Commissioner, 42 T.C.M. 1089 (1981). *Hutchison* involved a purchaser who defaulted on payments on the wrap around mortgage. A court had required the purchaser to make payments to the seller and his mortgagee separately. *Id.* at 1090. After the court terminated its supervision of the situation, the purchaser redeemed the seller of his interest in the property pursuant to a settlement. No specific agreement as to the payment of the mortgagee was reached. *Id.* at 1091. Payments were in fact made directly to the mortgagee by the purchaser after the settlement agreement. The Tax

mortgagee reflects in its records that the primary obligor has changed.[138] The seller, having received all his equity from the property, will appear to cease having an interest in the transaction and leave the property to satisfy the senior mortgage.[139] The purchaser in such a case will be treated as taking the property subject to the mortgage because he will pay the mortgage debt to prevent foreclosure on the property.[140]

C. A Comparison of the Tax Court's and Service's Approaches

The Tax Court has endeavored to allow taxpayer-sellers of property the deferral of income inherent in the wraparound mortgage transaction only when they demonstrate that purchaser payments on the first mortgage are "at risk" in their hands.[141] This requirement can be justified on theoretical grounds as well as on the ground of furthering the purpose of section 453.[142]

The Tax Court has injected the at risk requirement into the

Court found that this amounted to the purchaser taking the property subject to the existing mortgage. *See supra* note 127 and accompanying text.

138. *See* Hutchison v. Commissioner, 42 T.C.M. 1089, 1094 (1981). This would indicate that the mortgagee considered the purchaser to be the primary obligor and that the seller would be relieved of the primary responsibility on the debt. *Id.* *See supra* notes 103-13, 126-29 and accompanying text.

139. *See* Hutchison v. Commissioner, 42 T.C.M. 1089 (1981), in which the circumstances indicated that the seller had closed out his interest in the property, leaving the mortgagee and the purchaser to sort out their respective claims against the property.

140. *See id.* at 1094.

141. *See supra* notes 120-29 and accompanying text.

142. An argument can be made that the purpose of spreading recognition of income over payments as they are received should not apply to excess liability (mortgage over basis). The rationale is that the seller has already recognized the gain prior to sale by depreciating the property faster than the real value decreased or by receiving cash from taking out the mortgage on the property. Excess liability has created an inherent tax benefit by allowing the seller to use tax-free cash, obtained on a loan secured by appreciated property value which has not yet been taxed. Wiebusch v. Commissioner, 59 T.C. 777, 780-81 (1973). However, obtaining a loan in excess of basis on appreciated property is not an income recognition event. Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952). It is not clear why a disposition of the property on the installment method should cause recognition when the debt is not assumed. Where the property *is not* disposed of and the owner obtains a loan in excess of his basis in the property, the owner will pay back mortgage principal with after-tax dollars and interest with pre-tax dollars because of the interest deduction. Where the property *is* disposed of on the installment method the result is the same—the seller will recognize income before or concurrently with the payment on his mortgage principal, and therefore the mortgage will be paid with after-tax dollars. When the debt is not assumed, the seller has not closed out his interest in the property or his mortgage and his gain should be recognized ratably pursuant to section 453. This is consistent with the doctrine of the *Woodsam* case.

analysis used in determining the basis of an installment obligation, and, in so doing, it has made its wraparound cases comport with the basis analysis adopted by the Supreme Court in *Crane v. Commissioner*.[143] In *Crane*, the Supreme Court held that an assumed mortgage was included as part of the consideration paid for property. A corollary to that holding is that the adjusted basis of property includes the value of any mortgage used to finance the acquisition of the property.[144] The cost basis of property is thus determined by the economic cost of the property and not by whether it was purchased for cash or debt-financed.[145]

The installment obligation has a basis in the hands of the seller equal to the value of the property sold to the purchaser.[146] The obligation is not the equivalent of payment for the property, because the seller may be forced to repossess his former property should the purchaser default. Therefore, the installment obligation and the mortgage securing it do not represent a termination of the seller's interest in the property. Instead, the obligation acts as a substitute for the property until the purchaser makes actual payments for the property, each of which *pro tanto* terminates the seller's interest in the property.

The payments a seller receives on the installment obligation are part interest and part a return of his basis in the installment note.[147] The basis of the installment obligation will equal the face amount of the note or some lesser principal amount, depending upon whether interest is separately stated or included in the face value of the note.[148] The seller's basis in the installment obligation includes his first mortgage on the property. He has, in effect, borrowed money against the land to acquire the installment obligation. Since the installment obligation and the mortgage securing it are merely substitutes for the property, only when the seller receives actual payments on the installment note is his basis in the note liquidated; it is at that point that the tax consequences of the underlying sale of property should attach. As the note's basis is

143. 331 U.S. 1 (1947).

144. *Id.* at 11. *See* Millar v. Commissioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978); M. CHIRELSTEIN, FEDERAL INCOME TAXATION 229 (2d ed. 1979).

145. M. CHIRELSTEIN, *supra* note 144, at 228-30.

146. *See* Davies, Zumpano & Mansfield, *The IRS approach to the wrap-around mortgage: a contradiction of tax fundamentals*, 60 TAX ADVISER 260, 263 (1980).

147. Payment on any note is either a return of the money owed the holder of the note or interest paid to the holder to compensate him for not demanding immediate repayment of the value of the note. If the parties do not provide for interest, it will be imputed into the contract pursuant to I.R.C. § 483 (1976).

148. *See* Treas. Reg. § 1.483-2(a)(1)(i) (1966) (interest imputed into face amount of contract and treated as interest).

liquidated, the gain on the sale is recognized and the seller will pay tax on the gain before he makes payment to the mortgagee.

The Service has taken the position that whenever property is sold which is mortgaged in excess of its basis, the seller will recognize the excess as income in the year of sale.[149] This is the Service's approach even when a valid installment obligation and wraparound mortgage are taken in exchange for the property.[150] There are two problems with this approach. First, it ignores the fact that the installment obligation only suspends the seller's interest in his former property; termination occurs when the purchaser actually pays for the property.[151] Second, and more importantly, this approach ignores the *Crane* doctrine with respect to the installment obligation held by the seller.[152]

By requiring the seller to recognize gain on the excess of the mortgage on the *property* over his basis in the *property*, the Service ignores the fact that the seller holds an installment note with a basis equal to the *value* of the property which he exchanged for the note. Under the *Crane* doctrine, the basis of the installment obligation must include any debt financing used to acquire the obligation. This would encompass *all* mortgages on the property exchanged for the obligation, including those in excess of the property's basis, but less than or equal to its current value.[153] The

149. Temporary Treas. Reg. § 15a.453-1(b)(3)(ii), 1981-10 I.R.B. 14-15.

150. *Id.*

151. This is most clearly demonstrated by situations such as in United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963), and Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955), where the agreement between the parties explicitly provides for, and the seller in fact makes, payments on the senior mortgage until the purchaser formally assumes those payments. Before the assumption, while the seller is responsible for the senior debt service, he retains part of his equity in the property, secured by the second "wrapped" mortgage. Upon the formal assumption by the purchaser, the seller's remaining equity is usually paid to him in cash.

152. Davies, Zumpano & Mansfield, *supra* note 146, at 263.

153. In Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), the court held that obtaining a loan by mortgaging real property in excess of its basis was not an event in which income was recognized, even though the taxpayer received cash against the appreciated value of his property and the loan was nonrecourse, i.e., only the property could be used to satisfy the debt if the taxpayer defaulted. *Id.* at 359. As a corollary to this holding, the basis of the property was not increased because income was not recognized upon obtaining the loan. *Id.* Because there was no increase in basis, the taxpayer-owner realized a larger gain on the foreclosure sale of the property. *Id.* at 357-58. Gain on the foreclosure sale resulted because the existing mortgage on the property was in excess of its basis. However, under the *Crane* and *Woodsam* doctrines, the taxpayer could take the proceeds from the loan and purchase another depreciable or non-depreciable asset and receive a full cost basis for the new property, even though he had not paid tax on the money used to purchase the new property. *See* M. CHIRELSTEIN, *supra* note 144, at

Service apparently contemplates an exception to the *Crane* doctrine for installment obligations in that the basis of the obligation would depend on the method of financing the obligation rather than its economic cost.

In *Crane*, no distinction was drawn between recourse and nonrecourse financing of real property.[154] The Tax Court, however, has distinguished between valid and invalid wraparound mortgages which secure installment notes depending upon whether the debt remains fully recourse solely to the seller-mortgagor.[155] The reason for the Tax Court's distinction is that the basis of the installment note will depend upon whether the seller will actually receive payments on the note.[156] Where the purchaser pays the mortgagee directly, the seller will not have a basis in the note to the extent of the purchaser's direct payments. In such a case, the seller enjoys the benefit of debt relief in the year the property is sold. In contrast, where the seller-mortgagor remains primarily liable on the note, his liability will be full recourse, and the installment note will have a *basis* equal to the *value* of the property sold. The *Crane* analysis is appropriate in this situation. Hence, no constructive payment should be deemed received in the year of sale when property is sold subject to a mortgage in excess of basis and the basis of the installment note does, in fact, equal the value of the property.

The Internal Revenue Service has maintained a litigating posture that mortgaged property sold is inevitably sold subject to the mortgage. Thus the Service treats excess mortgage debt over basis as a payment received by the seller in the year of sale.[157] This position has been embodied in the new regulations[158] promulgated to carry out the provisions of section 453.[159] However, section 453

236-39. If it is consistent with *Crane* and *Woodsam* to allow tax-free borrowing against property when the proceeds are used to purchase another asset, it is also consistent with those cases to allow a taxpayer to receive an installment obligation (which is merely another asset) in exchange for property mortgaged in excess of basis without income recognition. Further, the installment obligation's basis should equal the full value of the property exchanged for it.

154. *See* Davies, Zumpano & Mansfield, *supra* note 146, at 263 n.15.

155. *See supra* notes 103-29 and accompanying text.

156. Some commentators believe that the courts should not base the determination of the validity of wraparound financing on whether the seller remains personally liable (full recourse) on the senior mortgage. *See* Davies, Zumpano & Mansfield, *supra* note 146, at 265.

157. *See supra* note 57. *But see* Priv. Let. Rul. 7814011 (Dec. 29, 1977); Priv. Let. Rul. 7814010 (Dec. 23, 1977).

158. Temporary Treas. Reg. § 15a.453-1(b)(3)(ii), 1981-10 I.R.B. 14-15.

159. Congress granted the Secretary of the Treasury the power to promulgate such regulations. I.R.C. § 453(i)(1) (Supp. IV 1980). This part provides: "The

does not address the issue of what constitutes a payment received in the context of a sale of mortgaged property.[160] The Installment Sales Revision Act of 1980 did not change any part of section 453 in a manner which would suggest that Congress meant to change the conception of what constitutes a payment in the year of sale in the case of a sale of mortgaged property.[161]

Wraparound mortgages are mentioned in the Senate Report as "ingenious . . . arrangements to qualify for installment method reporting."[162] This statement was made in the context of the thirty percent limitation provision of prior section 453, which often was violated in an invalid wraparound transaction or a regular installment land sale when the excess of the mortgage over basis was treated as a payment received in the year of sale.[163] The Senate Report indicates that it was the Finance Committee's understanding that "[i]f title passes in the year of sale, the Internal Revenue Service will treat the mortgage debt in excess of basis as a payment received in the year of the sale."[164] Thus the committee felt that it was eliminating the need to use wraparound mortgages by abolishing the thirty percent rule.[165] However, the Senate Report does not refer to the more basic use of the wraparound mortgage to defer recognition of income when installment reporting is available. Thus the underlying problem of timing the recognition of income remains.

The Installment Sales Revision Act eliminated the thirty percent rule and other technical qualifying sections in order to make installment reporting more accessible to and less obtrusive on normal business transactions.[166] The amendments to section 453 were meant to make installment reporting available when the economic substance of a transaction relating to the sale of property involved the receipt of payments over a period of time. The committee ac-

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Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section." *Id.*

160. *See* I.R.C. § 453(c) (Supp. IV 1980). Section 453(f) provides only that payment is not to include the receipt of evidences of indebtedness of the person acquiring the property.

161. *See* SENATE REPORT, *supra* note 14, at 7, 1980 U.S. CODE CONG. & AD. NEWS at 4701-02.

162. *Id.* at 9, 1980 U.S. CODE CONG. & AD. NEWS at 4703-04.

163. When the excess of mortgage over basis was deemed a payment received in the year of sale, more than 30% of the sale price would often be received in the year of sale, and under prior law this would disqualify the transaction from installment reporting. Wraparounds were used to circumvent the 30% rule.

164. SENATE REPORT, *supra* note 14, at 9, 1980 U.S. CODE CONG. & AD. NEWS at 4703-04.

165. *Id.* at 9-10, 1980 U.S. CODE CONG. & AD. NEWS at 4703-05.

166. *Id.* at 8, 1980 U.S. CODE CONG. & AD. NEWS at 4702-03.

knowledged that the purpose of section 453 was "to permit the spreading of the income tax over the period during which payments of the sales price [were] received."[167]

There appear to be two explanations for the provision in the regulations that any mortgaged property sold in a wraparound transaction shall be considered sold subject to the first mortgage. Neither explanation comports with economic reality or the purpose of section 453.

First, the regulations may intend to draw a distinction for tax purposes between a wraparound mortgage and an installment land contract or contract for deed.[168] If so, the regulations should be invalid. While there are differences between a wraparound mortgage and various types of land contracts, they are identical for purposes of defining the parties' responsibilities for making actual

167. *Id.* at 7, 1980 U.S. CODE CONG. & AD. NEWS at 4701-02.

168. Arguably, this distinction is implicit in the Senate Report. The Finance Committee assumed that the Service would only attack the wraparound-type transaction when title passed in the year of sale. *See supra* text accompanying notes 162-65. This has some support from two letter rulings. *See* Priv. Let. Rul. 7814011 (Dec. 29, 1977); Priv. Let. Rul. 7814010 (Dec. 23, 1977). In both situations involved, the *seller* made all payments to the mortgagee, but the purchaser had an option to pay the mortgagee directly upon the seller's default. Rather than assume its losing position reflected in United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963), Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958), and Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955), the Service attempted to distinguish those cases. The distinctions drawn were: (1) title did not pass in the year of sale in those cases, and (2) there were no options evident in the cases. It seems that the option to pay the mortgagee directly *after* the seller's *default* does not provide the purchaser any benefit he would not otherwise have regarding protecting property in his possession. *See supra* note 34 and accompanying text. This should be distinguished from a purchaser's option to pay the mortgagee *before* the seller's default. When default has occurred, the mortgagee has already gone through the formalities of demanding payment from the seller, the original mortgagor. This is proof that the mortgagee was looking primarily to the seller for payment of the mortgage. An option exercisable before default does not present these formalities and there is no proof that the mortgagee was looking primarily to the seller for its payment on the mortgage. In this latter case, it is likely that the purchaser will pay the seller's debt service directly by exercising the option before the seller defaults. In any case, in the circumstances of the letter rulings, the *seller* apparently did make the payments to the mortgagee. The Service apparently relied primarily on the location of legal title in the two letter rulings. This would be consistent with its position in Hutchison v. Commissioner, 42 T.C.M. 1089 (1981), and Goodman v. Commissioner, 74 T.C. 684 (1980), which both involved wraparound mortgages. However, as discussed earlier, location of title should not be relevant to tax consequences because it does not define a sale for tax purposes nor does it determine eligibility for installment method reporting. *See* Levinton, *supra* note 61, at 170; *supra* note 100. *But see* Gallagher, *Wraparound Mortgages and Deferred Payment Sales of Real Property*, 56 TAXES 400 (1978) (arguing that location of title is a good indicator for tax consequences in a wraparound transaction).

payments on the first mortgage.[169] Modernly, the location of legal title is becoming less relevant for purposes of defining the seller's remedies when the purchaser defaults in a sales transaction involving land.[170] Location of title is irrelevant for purposes of the application of section 453. Under section 453, the critical inquiry is whether the seller or purchaser is obligated, in fact, to make payments to the mortgagee. If the temporary regulations reflected this position, they would not have changed the law to any great extent. Installment land contracts would not fall under the proscription dealing with wraparounds, and they would carry the potential for beneficial tax treatment not expressly available for wraparounds under the temporary regulations. Litigation would continue under the "assumed or taken subject to" language retained in the temporary regulations[171] from the prior regulations[172] in cases where the taxpayer had the foresight to call his agreement an installment land contract. As noted above, there is no reason to draw a distinction between a wraparound mortgage and an installment land contract and only give the latter beneficial tax treatment.

The second, more likely explanation is that the regulations intend to preclude the sale of mortgaged property unless the buyer takes subject to or assumes the mortgage. If that is the intention, the regulations should also be held invalid because they do not further the purpose of section 453.[173] There may be substantive non-tax reasons for the use of either the wraparound mortgage or the analogous installment land contract.[174] When these financing devices are used, the purchaser and seller may have entered into a binding agreement under which the purchaser, in fact, remits all payments to the seller and the seller in fact, pays off the first mortgage with his own general funds. When a transaction is structured in this manner, there is no relief of the mortgage debt in the year of sale in any real economic sense. There seems to be no justifiable reason to deny the parties the inherent benefits of their transaction—the deferral of the gain realized because of the excess of the

169. *See supra* notes 88-90 and accompanying text.
170. *See* Comment, *supra* note 90, at 764, 776-88.
171. Temporary Treas. Reg. § 15a.453-1(b)(3)(i), 1981-10 I.R.B. 14-15.
172. Treas. Reg. § 1.453-4(c)(1960).
173. *See supra* notes 3, 95 and accompanying text.
174. The principal non-tax use of the wraparound mortgage is to provide financing at lower interest rates than market rates. This can benefit both the purchaser and the seller-mortgagor at the expense of the senior mortgagee. The seller can afford to charge the purchaser a lower rate of interest because of the leverage created by the inclusion of the low-interest senior mortgage in the amount on which the buyer will pay interest. Financing at the lower rate will also produce less burden on the property and assist in allowing it to pay for itself. Davies, Zumpano, and Mansfield, *supra* note 146, at 261 n.1.

mortgage over basis and the recognition of the gain as payments are actually received.

The Tax Court's approach in dealing with these transactions should be adopted in the final regulations because it effectively protects the interests of both the government and the taxpayer. When a transaction is found to in fact relieve the seller of his mortgage debt in the year of sale, recognition of income is appropriate. The parameters set forth by the Tax Court effectively define when a seller is relieved of his debt and, more importantly, when there is no debt relief.

III. STANDBY LETTERS OF CREDIT AS PAYMENTS RECEIVED IN THE YEAR OF SALE

When property is sold using the installment method, the seller will receive payment in the form of one or more installment notes. To secure payment of the notes, the seller frequently will retain a security interest in the property.[175] However, the purchaser may require an unencumbered title to the property,[176] or the seller may desire a more assured and liquid source of security for the installment notes in order to avoid the potential legal proceedings involved in a foreclosure or judicial sale.[177] A point of tension arises when the security is so assured and liquid that it appears that the seller has actually received payment for the property in the year of sale.[178]

The standby letter of credit is a flexible security device that has been used, with some success, to secure payment of installment notes and avoid the constructive receipt of payment problem.[179] The temporary regulations[180] and the Senate Report[181] accompanying the Installment Sales Revision Act of 1980 both manifest the

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175. For a discussion of this type of arrangement in the context of the wraparound mortgage or the installment land contract as the security device, see *supra* part II of this Comment.
176. *See, e.g.*, Rev. Rul. 79-91, 1979-1 C.B. 179 (escrow substituted for a deed of trust).
177. *See, e.g.*, Griffith v. Commissioner, 73 T.C. 933 (1980); Watson v. Commissioner, 69 T.C. 544 (1978), *aff'd*, 613 F.2d 594 (5th Cir. 1980).
178. *See infra* notes 242-56 and accompanying text.
179. *See* Sprague v. United States, 627 F.2d 1044 (10th Cir. 1980); Priv. Let. Rul. 8129092 (Apr. 23, 1981).
180. Temporary Treas. Reg. § 15a.453-1(b)(3)(i), (iii), 1981-10 I.R.B. 14-15.
181. SENATE REPORT, *supra* note 14, at 18, 1980 U.S. CODE CONG. & AD. NEWS at 4712-13. The Senate Report provides: "Under the bill, a third party guarantee (including a standby letter of credit) will not be taken into account in determining if the buyer's evidence of indebtedness constitutes payment to the seller." *Id. See also* I.R.C. § 453(f)(3) (Supp. IV 1980) (evidence of indebtedness of the purchaser is not payment when received regardless of whether or not it is guaranteed by a third party).

congressional intention that a standby letter of credit, *functioning as a third party guarantee*, will not be considered a payment received in the year of sale.

A letter of credit is an agreement made by an issuer, usually a bank, at the request of its customer, for the benefit of a third party.[182] The issuer promises to pay the beneficiary or to negotiate drafts drawn by the beneficiary when, as a condition precedent, the beneficiary presents the necessary documents.[183] These documents are specified in the letter of credit.[184]

There are two types of letters of credit: the commercial letter and the standby letter. The basic forms of the two types of letters of credit are identical,[185] but their purposes and the documents presented to initiate payment are different for each type.

As in the wraparound mortgage transaction, the standby letter of credit functions to allow the seller of property to defer taxable gain over the period of time in which payments are actually received.[186] In contrast, the commercial letter of credit does not function to allow a taxpayer to defer income because once the letter is in his possession it is a payment mechanism rather than a form of guarantee or security.[187] Therefore, regardless of the name given to a particular letter of credit, it is essential to be able to identify its true nature by the presence or absence of certain salient features.

In addition to assuring that the letter of credit will be deemed a standby letter of credit, the parties who choose to defer income through this mechanism must structure their transaction so that the letter is not treated as a payment received in the year that the taxpayer obtains possession of the letter. If the letter of credit is treated as a payment received in the year of sale, the entire gain on the sale will be taxed to the seller in the year of sale because all

182. *See* Harfield, *Letters of Credit*, 76 BANKING L.J. 93 (1959). Harfield's definition of a letter of credit is as follows:

> First, a letter of credit is a contract which stands by itself, entirely separate and distinct from the contract or other relation between the account party [the bank's customer] and the beneficiary, even though that contract or relationship may have been the genesis of the letter of credit. Second, in a letter of credit transaction, banks deal in documents and not in merchandise. Third, the terms and conditions of the contract which is embodied in the letter of credit must be strictly performed.

Id. at 101.

183. *Id.*

184. *Id.*

185. *See* Arnold & Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272, 277 (1978).

186. *See supra* notes 180-81 and accompanying text.

187. *See infra* notes 189-98 and accompanying text.

payments guaranteed by the letter of credit will be deemed actually received in the year of sale.[188]

This section of the Comment will define the attributes of a standby letter of credit which will adequately secure the seller of property and avoid the risk that the security will be deemed payment for the property in the year of sale.

A. The Commercial Letter of Credit

The commercial letter of credit is a mechanism of payment used in a sale of goods.[189] From the outset, it is intended that the seller will draw on the letter of credit as payment for the goods sold.[190] The following example illustrates a situation in which the commercial letter of credit might be used and the mechanics of its use. If a buyer and seller do not know each other, both may be wary of taking the first step in the deal. The seller will not want to send goods before receiving payment and the buyer will not want to pay until receiving the goods. A bank which has confidence in the buyer's ability to pay and which is known by the seller as a creditworthy party can aid the transaction.[191] The buyer will apply to the bank for a letter of credit in favor of the seller. The bank promises to pay the seller when it is presented with shipping documents and other documents which assure the quantity and quality of the goods shipped.[192] The buyer will reimburse or prepay the bank as well as pay a fee for the service.

It is important to note that any letter of credit is an agreement between the issuer (bank) and the beneficiary (seller) even though the buyer applies to the bank for the letter of credit; the buyer's application is an independent agreement.[193] The letter of credit is also separate and independent from the underlying agreement of sale between the buyer and the seller.[194] The bank's obligation to pay the seller is based only upon the presentation of the required documents;[195] the bank cannot escape its obligation to

188. Griffith v. Commissioner, 73 T.C. 933 (1980).

189. Asociacion De Azucareros De Guatemala v. United States Nat'l Bank, 423 F.2d 638 (9th Cir. 1970); Second Nat'l Bank v. Columbia Trust Co., 288 F. 17 (3d Cir. 1923).

190. *See* Arnold & Bransilver, *supra* note 185, at 278.

191. *Id.*

192. *Id.*

193. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 712-13 (2d ed. 1980).

194. *See* Venizelos, S.A. v. Chase Manhattan Bank, 294 F. Supp. 246, 248 (S.D.N.Y. 1968), *rev'd on other grounds*, 425 F.2d 461, (2d Cir. 1970); Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 146 N.E. 636 (1925); U.C.C. § 5-114(1) and Official Comment I.

195. Banco Espanol de Credito v. State St. Bank & Trust Co., 385 F.2d 230, 237 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968); Dulien Steel Prods., Inc. v. Bank-

pay by asserting any defenses against the seller based on the underlying agreement between the buyer and seller.[196]

The commercial letter of credit is an independent agreement whereby the credit of the bank is substituted for the credit of the buyer. The bank fully intends to pay the seller for the goods when the documents presented to it indicate that the seller has performed the underlying agreement.[197] When a commercial letter of credit is involved, the seller has constructive receipt of the payments embodied in the letter upon completion of his part of the agreement. This is because once the seller completes his performance under the agreement, he may collect the payment, at his discretion, by presenting the shipping and quality documents that he has procured through his performance.[198]

Thus, a nominal standby letter of credit will not in fact qualify as such when the documents which the seller must present to obtain payment merely confirm the seller's performance on the underlying agreement and his right to payment. This type of letter is a commercial letter of credit,[199] and payment is constructively received by the seller when the credit is issued and the required performance on the underlying agreement is completed.

This rationale was recognized in *Watson v. Commissioner*,[200] in a transaction in which the seller completed his contract for delivery of cotton and attempted to defer the income from the sale by postponing collection on the letter of credit he had received in payment until the following year. The Tax Court found that the letter of credit was the equivalent of cash[201] because it could be drawn upon and converted into cash by presenting the documents which proved delivery of the cotton. Because the seller had possession of these documents from the time of delivery,[202] he was required to

ers Trust Co., 189 F. Supp. 922, 927 (S.D.N.Y. 1960), *aff'd*, 298 F.2d 836 (2d Cir. 1962).

196. If the documents are forged or if there is fraud involved in the transaction, (e.g., the seller fraudulently gives a misdescription of the goods shipped to the buyer), the bank will be excused from honoring the letter of credit. Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 718, 31 N.Y.S.2d 631 (Sup. Ct. 1941). Even this exception is narrowly construed. *See* Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C. L.J. 251, 256 (1972).

197. *See* Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 718-21 (1973).

198. *See* Watson v. Commissioner, 69 T.C. 544 (1978), *aff'd*, 613 F.2d 594 (5th Cir. 1980).

199. The bank will receive documents of title from the seller which activate its obligation to honor the letter of credit. The bank will simultaneously become a secured creditor of the buyer by virtue of its possession of the documents of title to the buyer's goods. *See* Verkuil, *supra* note 197, at 721.

200. 69 T.C. 544 (1978), *aff'd*, 613 F.2d 594 (5th Cir. 1980).

201. 69 T.C. at 552.

202. *Id.* at 551.

recognize income in the year of delivery under the cash-equivalency theory.[203]

It may appear that immediate income recognition could be avoided in the above situation by a provision in the letter of credit specifically making payment due in a subsequent year.[204] However, this attempt at income deferral will fail. If the proceeds of the letter of credit are assignable, it is still the equivalent of cash.[205]

The commercial letter of credit is assignable and its cash equivalency retained because potential assignees (usually banks) are willing to discount letters of credit and advance cash to sellers in exchange for the letters of credit. The seller will be able to assign the letter of credit because assignees know that the issuing bank will be required to pay the amount due upon presentation of the specified delivery documents, regardless of any defenses on the underlying transaction between the buyer and seller.[206]

The commercial letter of credit transaction itself is executory until the seller or his assignees present the shipping and quality documents prescribed in the letter of credit.[207] When that occurs, the bank becomes obligated on the letter of credit and will pay the seller from its own funds. From that point, the bank has loaned its money to the buyer and the buyer is absolutely obligated to reimburse the bank pursuant to its application for the letter of credit,[208] regardless of whether the goods comply with the underlying contract of sale.[209] The bank acquires a perfected security interest in the documents of title covering the goods simultaneously with the creation of the loan.[210] The documents of title thus secure the buyer's absolute obligation to reimburse the bank, and the bank is maximally secured in a transaction in which it knows that it will be required to make payment on the letter of credit.

From *Watson* and the temporary regulation language referring

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203. *Id.* at 552.
204. *See id.* at 553.
205. *Id.* at 551. The court noted: "Security Bank had received the purchase price of the cotton . . . and, therefore, had no legitimate concern as to whether it paid peititoner or someone else . . . . Consistent with these realities, . . . even though the letter of credit states it is nontransferable . . . , the beneficiary may 'assign his right to proceeds'." *Id.*
206. *See supra* notes 193-96 and accompanying text.
207. Verkuil, *supra* note 197, at 723.
208. *See* 12 C.F.R. § 7.7016 (1981), which provides: "[L]etters of credit should be issued in conformity with the following: . . . (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit." *See, e.g.*, Dulien Steel Prods., Inc. v. Bankers Trust Co., 189 F. Supp. 922, 927 (S.D.N.Y. 1960), *aff'd*, 298 F.2d 836 (2d Cir. 1962).
209. Verkuil, *supra* note 197, at 720 & n.26.
210. *Id.* at 721.

to a standby letter of credit functioning as a guarantee between the parties,[211] it is clear that the letter of credit which Congress contemplated would not constitute receipt of payment in the year of sale is different from the traditional commercial letter of credit in one major respect. The parties must not look to the letter of credit as the primary source from which payment for the sale will be made.[212]

The necessity of keeping the primary source of payment separate from the security in a transaction is consistent with the general theory of constructive receipt developed by the Tax Court in escrow cases.[213] When payments on an installment note are secured by funds placed in escrow, the seller will be treated as having received the payments in escrow in the year of sale unless there is a substantial restriction on the certainty of the funds becoming available to him.[214] This result obtains because the escrow, rather than the buyer, is the primary source from which payment on the notes will be collected.[215] Unless there is some

211. Temporary Treas. Reg. § 15a.453-1(b)(3)(iii), 1981-10 I.R.B. 14-15. The regulation provides in part: "The term 'standby letter of credit' means a non-negotiable, non-transferable . . . letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit." *Id.*

212. *Id.*

213. *See, e.g.*, Trivett v. Commissioner, T.C.M. (P-H) ¶ 77,161 (1977), *aff'd*, 611 F.2d 655 (6th Cir. 1979); Oden v. Commissioner, 56 T.C. 569 (1971); Pozzi v. Commissioner, 49 T.C. 119 (1967).

214. Rev. Rul. 79-91, 1979-1 C.B. 179. The restriction must be the result of a substantive contingency regarding the availability of the funds to the seller. The contingency should be for the benefit of the purchaser. For example, in Stiles v. Commissioner, 69 T.C. 558 (1978), the court held that there was no constructive receipt of funds placed in escrow. The trustee had discretion to prevent the funds from passing to the seller if it determined that the seller had not disclosed his knowledge of liabilities of the corporation whose stock was the subject of the installment sale. Additionally, if any self-dealing arrangements between the seller and the corporation had been discovered, the escrowed funds would have been forfeited to an appropriate extent.

215. Oden v. Commissioner, 56 T.C. 569 (1971). In *Oden*, payments were made to the seller directly from the escrow account. The bank, which also served as escrow agent, would cash a certificate of deposit placed in escrow (and in a face amount equal to each installment payment) and send a check for the interest earned to the buyer and deliver the face amount directly to the seller by a bank check. The seller was found to have constructively received the payments when they were placed in escrow. In Pozzi v. Commissioner, 49 T.C. 119 (1967), the formalities of treating the escrow as security were observed and payments were not made directly from the escrow account to the seller. Instead the buyer remitted payment to a bank, which then deposited the payment in the seller's account. The bank was also the trustee of the funds escrowed as security for the buyer's obligation to pay the seller, and, as each payment was received, a portion of the escrowed funds was released to the buyer. The seller was found to be in constructive receipt of the escrowed

restriction other than the passage of time on the availability of the funds to the seller,[216] the seller has the certain economic benefit of the escrow from the moment the escrow is created.[217]

Thus it is initially possible to identify two features of a letter of credit which will not pass muster under the temporary regulations. First, the parties should not intend to use the letter of credit as the primary source of payments.[218] Second, the documents presented to trigger payment on the letter of credit should not be a confirmation that the seller has performed his obligations and is thus entitled to demand payment.[219]

B. The Standby Letter of Credit and its Role as a Guarantee

As noted previously, a standby letter of credit is identical in form to a commercial letter of credit.[220] The differences for tax purposes may be gleaned from the negative implications of the commercial letter of credit. A standby letter of credit operates as a guarantee of or security for payment rather than as a mechanism of payment;[221] accordingly, the parties do not expect the credit to be drawn upon.[222] Moreover, the documents presented to initiate and authorize payment under the standby letter of credit consist of a draft, plus documents which certify the buyer's nonperformance or default on its installment obligation.[223] As discussed, the documents presented in a commercial letter of credit transaction prove the seller's performance.

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funds in the year of sale because the court viewed the circuitous routing of money as a sham. *Id.* at 128. *See* Comment, *Installment Sales—Income Tax Consequences of Certificates of Deposit as Security*, 41 TENN. L. REV. 113 (1973).

216. *See* Rev. Rul. 79-91, 1979-1 C.B. 179.
217. *See* Trivett v. Commissioner, T.C.M. (P-H) ¶ 77,161 (1977), *aff'd*, 611 F.2d 655 (6th Cir. 1979).
218. *See supra* notes 199-205 and accompanying text.
219. *See supra* notes 216-17 and accompanying text.
220. *See supra* note 185 and accompanying text.
221. 12 C.F.R. §§ 7.1160(a), 337.2(a) (1981). Both the F.D.I.C. (*id.* § 337.2(a)) and the Comptroller of the Currency (*id.* § 7.1160(a)) define the standby letter of credit identically:

> A "standby letter of credit" is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary [the seller] on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party [the purchaser, who is also the bank's customer] or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.

222. 12 C.F.R. § 7.1160(a) n.1 (1981). *See* Arnold & Bransilver, *supra* note 185, at 279.
223. Chase Manhattan Bank v. Equibank, 550 F.2d 882 (3d Cir. 1977); Prudential Ins. Co. of Am. v. Marquette Nat'l Bank, 419 F. Supp. 734 (D. Minn. 1976).

The primary function of the standby letter of credit is to assure a creditor that its debtor will repay indebtedness to the creditor.[224] The letter serves as security for a note, and neither the bank nor its customer (the buyer or the person seeking the bank's credit) anticipate that the letter will be the primary source from which payment will be made. However, the bank does lend its credit to the customer,[225] and the letter of credit is treated as a loan to the customer.[226] The nature of the "loan" in a standby letter of credit transaction is different from the "loan" in a commercial letter of credit situation. The loan in the former is inherently unsecured, and thus the bank will often attempt to protect itself by requiring security before issuing the credit. This requirement of security gives rise to a constructive receipt problem which is discussed below.

When a standby letter of credit is used, the customer/buyer already has a definite obligation to pay a party to a transaction, and the bank bears the risk that the customer will not pay. The documents which trigger the bank's obligation to pay are affidavits of its customer's default. These documents do not provide any security which assures the bank of recouping the payment made for its customer as is the case with the commercial letter of credit transaction.[227] As one commentator noted: "Banks do not receive the face amount of the standby letter of credit at the time of issuance, as they do when they issue a certificate of deposit . . . ."[228] The standby credit is thus the functional equivalent of an unsecured loan because of the possibility that the customer will default, and the bank will be required to pay its own money under the letter of credit.

Standby letters of credit are treated as loans in calculating a customer's loan limit,[229] and such letters are only issued after the bank engages in a credit analysis equal to that required for an actual loan.[230] The bank will take a security interest in the customer's property to the extent deemed necessary to adequately assure the recovery of its potential payment on behalf of its customer.[231] As discussed later,[232] the type of security the bank re-

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224. *See supra* note 221.
225. Harfield, *supra* note 196, at 259.
226. 12 C.F.R. §§ 7.1160(b), 337.2(b) (1981).
227. The bank thus runs the risk of becoming an unsecured creditor, which would threaten bank solvency. *See* Verkuil, *supra* note 197, at 723.
228. Arnold & Bransilver, *supra* note 185, at 287.
229. 12 C.F.R. § 7.1160(b) (1981) (national banks); *id.* § 337.2(b) (state banks through F.D.I.C. regulations). Commercial letters of credit are not subject to the lending limit requirements. *Id.* §§ 7.1160, 337.2.
230. *See* Arnold & Bransilver, *supra* note 185, at 285.
231. Griffith v. Commissioner, 73 T.C. 933 (1980).

quires of the *buyer* of property may become important in determining whether the value of the standby letter of credit is recognized as income by the *seller*.

The standby letter of credit must function as a third party guarantee if its value is not to be deemed a payment in the year of sale under the temporary regulations.[233] This requirement appears to mean that the bank must become obligated to extend its own credit for the benefit of the seller of property to assure payment of the buyer's (its customer's) installment obligation to the seller. The bank would not serve as the primary source of payment on the underlying obligation, or as an agent, holding the buyer's funds in a segregated account for the benefit of the seller. Rather, the standby letter of credit must be an agreement whereby the *general credit*[234] of the bank secures its customer's (the buyer's) obligations.[235] As evidence that the letter of credit is only security for the obligation, documentation of default on a bona fide underlying installment note should be required.[236]

In the usual standby letter of credit transaction, the credit will be secured by the general funds of the bank rather than the specifically identified funds of the customer. Although the standby letter of credit functions as a guarantee because the bank uses its funds to guarantee payment of the customer's obligation, it is not a guarantee as that term is generally understood.[237] With the ordinary guarantee, an obligation arises under the guarantee only after the primary obligor has *in fact*[238] defaulted on the underlying guaranteed obligation. The guarantor is secondarily liable on the *same* agreement that bound the primary obligor, and any defenses to nonperformance available to the primary obligor are also available

232. *See infra* notes 242-59 and accompanying text.
233. Temporary Treas. Reg. § 15a.453-1(b)(3)(iii), 1981-10 I.R.B. 14-15.
234. By virtue of its independence from the underlying agreement between the buyer and seller, the bank is primarily liable on the letter of credit. *See infra* notes 237-41 and accompanying text. This requires the bank to put its own credit behind the letter of credit. U.C.C § 5-117 and Official Comment. The comment provides: "[T]he bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit." U.C.C. § 5-117, Official Comment.
235. If the bank held its customer's payment for disbursement to the seller, it would act as an escrow agent and the amount so held would be constructively received by the seller. *See supra* notes 213-17 and accompanying text.
236. *See infra* notes 267-72 and accompanying text.
237. Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973), *cert. denied*, 414 U.S. 1139 (1974); Fidelity Bank v. Lutheran Mut. Life Ins. Co., 465 F.2d 211 (10th Cir. 1972); Prudential Ins. Co. of Am. v. Marquette Nat'l Bank, 419 F. Supp. 734 (D. Minn. 1976); American Empire Ins. Co. v. Hanover Nat'l Bank, 409 F. Supp. 459 (M.D. Pa. 1976).
238. *See* Arnold & Bransilver, *supra* note 185, at 279.

to the guarantor.[239] In contrast, the standby letter of credit is an independent agreement between the bank and beneficiary (seller), and the seller may recover upon presenting the bank with documents demonstrating default of the obligor, whether or not default has in fact occurred.[240] The primary liability of the bank on this separate agreement[241] indicates that its general funds are used to pay the standby credit. The bank must rely on whatever security it has procured to obtain reimbursement from its customer, the defaulting purchaser.

Prior to the temporary regulations, the Service argued that a standby letter of credit should be treated as a payment actually received by the seller, the beneficiary of the letter.[242] The predominate theory was that the seller had constructively received the value of the letter of credit. The temporary regulations, however, contemplate that standby letters of credit may not always be subject to constructive receipt treatment, and provide some guidance in that regard. For example, to avoid being treated as a payment received in the year of sale, the standby letter of credit must

239. *See, e.g.*, Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285 (9th Cir. 1974). In *Wichita Eagle*, the court found that a purported letter of credit was in reality a guarantee because the bank's obligation to pay under the letter of credit was premised upon demonstration of factual default on the underlying agreement rather than on the presentation of documents. The court stated:

> Where, as here, the substantive provisions require the issuer to deal not simply in documents alone, but in facts relating to the performance of a separate contract (the lease, in this case), all distinction between a letter of credit and an ordinary guaranty contract would be obliterated by regarding the instrument as a letter of credit.

Id. at 1286. In other words, if the issuer is secondarily liable on the primary obligor's agreement, a guarantee exists. *See* Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1236 (5th Cir. 1973), *cert. denied*, 414 U.S. 1139 (1974).

240. Even if the underlying agreement between the buyer and seller is illegal or has been modified, the letter of credit securing performance on the agreement must be honored by the issuer upon presentation of the appropriate documents. Fidelity Bank v. Lutheran Mut. Life Ins. Co., 465 F.2d 211 (10th Cir. 1972) (modification); Prudential Ins. Co. of Am. v. Marquette Nat'l Bank, 419 F. Supp. 734 (D. Minn. 1976) (illegality). In the letter of credit transaction, the bank cannot look beyond the validity of the documents when determining whether it is obligated to honor the credit.

241. The standby letter of credit transaction involves three separate agreements: the underlying agreement (in this context, the installment note), the application for the letter of credit, and the letter of credit itself. All three are independent from each other, including the application, which is solely between the issuer and the customer. Chase Manhattan Bank v. Equibank, 550 F.2d 882 (3d Cir. 1977).

242. *See, e.g.*, Griffith v. Commissioner, 73 T.C. 933 (1980); Watson v. Commissioner, 69 T.C. 544 (1978), *aff'd*, 613 F.2d 594 (5th Cir. 1980).

be irrevocable and nonassignable under local law.[243] However, the regulations provide that the proceeds of the letter of credit may be assigned without affecting the instrument's qualification as a standby letter of credit.[244]

Despite the above provisions, the temporary regulations do not directly address a major issue in the application of the constructive receipt theory to standby letters of credit. There appears to be a proposition developing under which the validity of the standby letter of credit may turn on the type of security that the issuing bank requires from the buyer/customer in the *application* for the letter of credit.[245] If the requisite collateral is illiquid property, the credit will stand. However, if certificates of deposit are required, the letter of credit may be deemed the equivalent of an escrow account, and the seller will recognize income upon creation of the letter of credit through the application of the constructive receipt theory.[246] Since the regulations do not directly address and resolve this issue, a brief recounting of the development of this proposition will be provided, followed by an inquiry into the propriety of basing the validity of a standby letter of credit on the type of security that the issuing bank requires from the buyer in the application for the credit.

In *Griffith v. Commissioner*,[247] the bank issuing the letter of credit required its customer, the buyer, to provide certificates of deposit as security to protect it in the event of the customer's default on the underlying obligation and the bank's payment under the letter of credit.[248] The court held that the bank was actually holding the certificates of deposit for eventual payment to the beneficiary-seller.[249] The court apparently viewed the safe, liquid nature of the security as an indication that the letter of credit was intended to serve as the primary source of payment of the buyer's installment obligation to the seller, analogous to an escrow transaction.[250] Therefore, the court found that the value of the letter of

243. Temporary Treas. Reg. § 15a.453-1(b)(3)(iii), 1981-10 I.R.B. 14-15.
244. *Id.* This provision will eliminate complicated factual inquiries as to whether the seller could obtain the market value of the note by discounting it in the marketplace. *See* Sprague v. United States, 627 F.2d 1044, 1049-50 (10th Cir. 1980) (complicated factual analysis demonstrating that the seller could not have obtained the fair market value of the installment note by assigning the proceeds of the letter of credit securing the note).
245. *See infra* notes 247-59 and accompanying text.
246. *See infra* notes 247-52 and accompanying text.
247. 73 T.C. 933 (1980).
248. *Id.* at 936.
249. *Id.* at 943.
250. The court primarily relied upon Oden v. Commissioner, 50 T.C. 569 (1971). *Id.* at 943. In *Oden*, the bank served as an escrow agent and not as a primary obligor on a letter of credit. *See supra* note 215.

credit was constructively received in the year of sale,[251] and, in effect, ignored the separate nature of the application for the letter of credit and the letter of credit itself.[252]

It is not clear if reasons other than the nature of the security led to the *Griffith* court's treatment of the standby letter of credit as similar to an escrow arrangement. There were substantial differences. The letter of credit was an independent agreement between the seller and the bank, and the seller looked to the general credit of the bank for his payment. The bank's reimbursement agreement with the buyer was of no concern to the seller because the seller was not a party to that agreement.[253] Further, the seller could collect on the letter of credit only after presenting the bank documentation of the buyer's default.[254] The court apparently considered the documentation of default a sham, but it did not indicate why the documents were not bona fide affidavits of default on the underlying installment note.[255]

Nevertheless, the *Griffith* analysis poses the risk that when certificates of deposit or other types of liquid security are utilized in a standby letter of credit transaction, the court may collapse the separate application for the letter of credit and the letter itself into one agreement. As a result, the bank, the buyer, and the seller are treated as parties to a transaction in which the bank functions as an escrow agent for the buyer and seller.[256]

A further illustration of the emphasis that courts may be giving to the type of security required by the issuing bank is reflected in *Sprague v. United States*.[257] In that case, the court held that a standby letter of credit did not constitute a payment in the year of sale of the property involved. One of the bases for the court's holding was that the bank did *not* require certificates of deposit as security[258] for its customer's obligation to reimburse the bank in the event that it was required to pay under the letter of credit. Similarly, Letter Ruling 8129092,[259] issued after and relying upon the temporary regulations, also appears to place some emphasis on

251. 73 T.C. at 943.
252. *See supra* note 241 and accompanying text.
253. *See supra* note 241.
254. 73 T.C. at 938.
255. *Id.* The default documents were to be prepared solely by the seller and no notice of default was required to be sent to the buyer before drawing upon the bank's letter of credit. This unilateral ability to invoke the terms of the letter of credit led the court to find that the seller had constructively received the value of the letter of credit. *Id.*
256. *See* Griffith v. Commissioner, 73 T.C. 933, 935-36 (1980).
257. 627 F.2d 1044 (10th Cir. 1980).
258. *Id.* at 1049-50.
259. Priv. Let. Rul. 8129092 (Apr. 23, 1981).

the nature of the collateral that the bank requires as security from its customer. In the Letter Ruling, the Service indicated that the standby letter of credit involved would not constitute a payment in the year of sale. One relevant factor was that the bank charged a fee to issue the letter of credit, but that the seller did not deposit the amount of the installment notes as collateral with the bank.

The type of security that an issuing bank requires from its customer (the buyer) appears to be a poor factor upon which to base the validity of a standby letter of credit for several reasons. First, constructive receipt issue should be foreclosed because the standby letter of credit, by its terms and legal interpretation, creates a primary obligation[260] between the bank and the beneficiary-seller, pursuant to which the seller looks to the bank for payment. The arrangements for the bank's repayment should not affect the standby letter of credit as they are controlled by the application for the letter of credit,[261] an agreement between the bank and its customer, the buyer. The seller is not a party to that agreement, and his tax consequences should not depend upon the type of security demanded by his purchaser's bank.

Second, focusing on the nature of the security would result in different tax consequences in two identical transactions. This type of result has been rejected in cases in which taxpayers have attempted to justify deductions on the theory that a well-secured note, given as payment for an obligation, was the equivalent of cash.[262] In these cases, the well-secured notes, certain to be paid, were found not to be the equivalent of cash. The nature and quality of the collateral which secured the notes was not relevant to the issue of when amounts were deemed paid for purposes of taking a deduction, and there is no apparent reason for treating this issue differently in the constructive receipt situation.

Finally, the temporary regulations do not contain language which compels the conclusion that the nature of collateral required by the buyer's bank must be considered in determining the validity of a standby letter of credit. The regulations provide:

> Payments include amounts actually or constructively received in the taxable year. . . . Receipt of an *evidence of indebtedness* which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment.[263]

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260. *See supra* notes 220-41 and accompanying text.
261. *See supra* notes 208, 241 and accompanying text.
262. *See, e.g.*, Williams v. Commissioner, 429 U.S. 569 (1977); Helvering v. Price, 309 U.S. 409 (1940); Eckert v. Burnet, 283 U.S. 140 (1931); Patmon, Young & Kirk, P.C. v. Commissioner, 536 F.2d 142 (6th Cir. 1976); Wasatch Chemical Co. v. Commissioner, 37 T.C. 817 (1962), *remanded*, 313 F.2d 843 (10th Cir. 1963).
263. Temporary Treas. Reg. § 15a.453-1(b)(3)(i), 1981-10 I.R.B. 14-15 (emphasis added).

This language does not address a standby letter of credit issued by a bank for the benefit of a seller. Such a credit is not an evidence of indebtedness between the bank and the seller. The seller's evidence of indebtedness is the buyer's installment note, which is secured directly by the general credit of the bank.[264] While the bank's loan of credit may be secured directly by a cash equivalent, that security is a feature of the agreement between the bank and its customer, embodied in the application for the letter of credit.[265] Such security is required to protect the bank, not the seller. Further, it appears that the seller's note is not even indirectly secured by a cash equivalent because the seller does not ordinarily look beyond the bank to collect when the buyer defaults on the note.[266] Thus, as long as the standby letter of credit is structured so that the general credit of the bank secures the installment note, constructive receipt of the value of the standby letter of credit should not be found.

A final feature which is essential for an instrument to qualify as a standby letter of credit relates to the necessity of proving default on the underlying installment obligation before drawing upon the letter of credit.[267] In *Griffith v. Commissioner*,[268] the required documentation of default was a simple affidavit signed by the seller. The Tax Court was reluctant to find substance in this type of arrangement because it appeared that it was too easy for the seller to fall back on the bank's security.[269] In *Sprague v. United States*,[270] the same unilateral type of documentation was required, but the court found that the transaction nevertheless had substance because of additional circumstances present in the case. The buyer had sued to enjoin the seller from collecting directly on the letter of credit; thus it appeared that the buyer wanted the credit to function as security rather than as a substitute for its underlying installment obligation.[271]

A more conservative course of action would be for the parties to require that the documentation of the buyer's default include a bilateral communication between the buyer and seller. For example, the seller could send an initial notice of default to both the buyer

264. *See supra* notes 234-41 and accompanying text.
265. *See supra* notes 208, 241 and accompanying text.
266. American Empire Ins. Co. v. Hanover Nat'l Bank, 409 F. Supp. 459, 464 (1976).
267. *See* Temporary Treas. Reg. § 15a.453-1(b)(3)(iii), 1981-10 I.R.B. 14-15 which provides: "A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness."
268. 73 T.C. 933 (1980).
269. *See supra* note 255.
270. 627 F.2d 1044 (10th Cir. 1980).
271. *Id.* at 1050.

and the bank, requesting the buyer to cure its default. After a reasonable time had elapsed, perhaps thirty days, the seller could send the bank a second notice reaffirming the default and the lack of curative action by the buyer. At this time, the seller could exercise the election to collect under the standby letter of credit. A similar procedure was deemed adequate in Letter Ruling 8129092.[272]

When complete documentation of default is assured and the instrument provides that the general credit of the bank is the seller's source of security, a valid standby letter of credit should be found to exist. Additionally, the buyer should avoid depositing cash equal to the face amount of the installment obligation[273] to secure his reimbursement obligation to the bank. When these procedures are followed, the standby letter of credit should not constitue receipt of payment in the year of sale of the property.

IV. CONCLUSION

By using the wraparound mortgage and the standby letter of credit in transactions involving sales of property, taxpayers have the opportunity to spread recognition of income over the payments as they are actually received under an installment obligation. When transactions involving these devices are carefully planned, taxpayers should be able to attain the beneficial results contemplated by the installment sales provision of the Internal Revenue Code. Yet income recognition which is triggered by the constructive receipt of payment in the year of sale remains an important issue in installment sales reporting. In the case of the wraparound mortgage, the temporary regulations are arguably invalid, and the benefits of the wraparound device should be attainable by structuring the transaction along the judicially defined parameters in the area. With respect to the standby letter of credit, favorable treatment should be available by following the guidelines set forth in the temporary regulations and interpreting them with an awareness of the general letter of credit case law.

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272. Priv. Let. Rul. 8129092 (Apr. 23, 1981).
273. *See supra* notes 245-59 and accompanying text.