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In this article, the authors explore how taxpayers and promoters will be affected by the government's plan to make monetized installment sales a listed transaction, and they explain the options available to participants in those transactions.

After repeated losses under the Administrative Procedures Act on listing transactions by notice,[1] the IRS is changing tactics — albeit under protest — and listing transactions by regulation.[2] That's the case with monetized installment sale transactions, which are the target of proposed regulations released August 3.[3]

This comes as little surprise. One consequence of the IRS designating a transaction as a listed transaction by regulation is that the government may disclose the IRS's intention to do so long before the agency formally proposes published guidance. The administration's spring 2023 unified agenda revealed that Treasury and the IRS were working on listing monetized installment sale transactions. This was confirmed by a document that appeared on the Office of Information and Regulatory Affairs website, indicating that Treasury intended to issue proposed regulations by December identifying monetized installment sale transactions as a listed transaction.[4]

Even before issuing the proposed regulations, the IRS had begun to undertake serious enforcement efforts against monetized installment sale transactions. The recently proposed regulations will increase the pressure on participating taxpayers and material advisers even further. In this article, we explain what a monetized installment sale transaction is and what the IRS has said about it, and we provide

[1] *CIC Services LLC v. IRS*, 141 S. Ct. 1582 (2021); *Mann Construction v. United States*, 27 F.4th 1138, 1147 (6th Cir. 2022); *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022); *GBX Associates LLC v. United States*, No. 1:22-cv-401 (N.D. Ohio 2022); *Green Rock LLC v. IRS*, No. 2:21-cv-01320 (N.D. Ala. 2023).

[2] *See, e.g.*, REG-106134-22 (syndicated conservation easement transactions); REG-109309-22 (microcaptive insurance transactions); and REG-106228-22 (Malta personal retirement scheme).

[3] REG-109348-22.

[4] OIRA, "Identification of Monetized Installment Sale Transactions as Listed Transactions" (Spring 2023).

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some possible courses of action for taxpayers and their advisers.

What Is a Monetized Installment Sale?

In general, a qualified installment sale allows taxpayers to defer gain on the sale of an appreciated asset when one or more payments are received after the year of the transaction.[5] Many other limitations apply, both on the character of the asset sold and the parties involved, but the effect is that a taxpayer does not recognize all the gain in the year of the sale — rather, the taxpayer recognizes a portion of the gain with each installment it receives. This treatment is premised on the fact that the seller will be receiving the proceeds of the sale over time, so from a taxing perspective, it doesn't make sense to tax the seller before he or she realizes the economic benefit of that sale.

The monetization of an installment sale happens when an intermediary places the full sale proceeds in escrow, grants the seller an installment note, and the seller attains a separate loan (secured by the escrowed funds) for nearly the same amount as the sale proceeds. To explain in more detail, a monetized installment sale transaction involves a seller, a buyer, an intermediary, and a lender. In a simple example of one possible iteration, Seller agrees to sell Asset A to Intermediary for $X. Intermediary will pay $X over time to Seller, usually with a balloon payment at the end of the agreement. Intermediary then sells A to Buyer for $X. Buyer pays Intermediary $X upfront, so Intermediary reports no gain or loss on the transaction. Intermediary takes the proceeds and places a portion in escrow. Seller then obtains a loan from Lender for $X, secured by the escrowed funds, under which the loan repayments match the payment schedule from Intermediary. The ultimate result is that Seller sells A for $X, obtaining the use of $X in year 1 while simultaneously delaying full recognition of the gain under the installment method on the note from Intermediary.

The IRS's Position

In 2019 the IRS Office of Chief Counsel, in emailed chief counsel advice,[6] advised IRS lawyers regarding the potential theories or issues that could be used to attack what the memo refers to as monetized installment sale transactions. This advice, eventually released May 7, 2021, raises several issues, including:

1. No genuine indebtedness. At least one promoter contends that the seller receives the proceeds of an unsecured nonrecourse loan from a lender, but a genuine nonrecourse loan must be secured by collateral. A "borrower" who is not personally liable and has not pledged collateral would have no reason to repay a purported "loan." See Estate of Franklin v. CIR, 544 F.2d 1045 (9th Cir. 1976). Therefore, the loan proceeds would be income.
2. Debt secured by escrow. In one arrangement, the promoter states that the lender can look only to the cash escrow for payment. It appears that, in effect, the cash escrow is security for the loan to taxpayer. If so, taxpayer economically benefits from the cash escrow and should be treated as receiving payment under the "economic benefit" doctrine for purposes of section 453. Compare Reed v. CIR, 723 F.2d 138 (1st Cir. 1983).
3. Debt secured by dealer note. Alternatively, the Monetization Loan to taxpayer is secured by the right to payment from the escrow under the installment note from the dealer. This would result in deemed payment under the pledging rule, under which loan proceeds are treated as payment of the dealer note. Section 453A(d).
4. Section 453(f). The intermediary does not appear to be the true buyer of the asset sold by taxpayer. Under section 453(f), only debt instruments from an "acquirer" can be excluded from the definition of payment and thus not constitute payment for purposes of section 453. Debt

[5] Section 453.

[6] ECC 202118016.

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instruments issued by a party that is not the "acquirer" would be considered payment, requiring recognition of gain. See Rev. Rul. 77-414, 1977-2 C.B. 299; Rev. Rul. 73-157, 1973-1 C.B. 213; and Wrenn v. CIR, 67 T.C. 576 (1976) (intermediaries ignored in a back-to-back sale situation).

5. Cash Security. To the extent the installment note from the intermediary to the seller is secured by a cash escrow, taxpayer is treated as receiving payment irrespective of the pledging rule. Treas. Reg. section 15a.453-1(b)(3) ("Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent . . . will be treated as the receipt of payment.").[7]

The IRS noted that not all of these arguments will apply in every transaction.

Less than two months later, the IRS added "Improper Monetized Installment Sales" to its "Dirty Dozen" list, describing the transactions as follows:

> These transactions occur when an intermediary purchases appreciated property from a seller in exchange for an installment note, which typically provides for payments of interest only, with principal being paid at the end of the term. In these arrangements, the seller gets the lion's share of the proceeds but improperly delays the gain recognition on the appreciated property until the final payment on the installment note, often slated for many years later.[8]

Since it first appeared in 2021, the monetized installment sale transaction has appeared on each version of the "Dirty Dozen" list.[9]

In June 2022 the IRS changed its description of the monetized installment sale transaction in its "Dirty Dozen" list:

> These transactions involve the *inappropriate use* of the installment sale rules under section 453 by a seller who, in the year of a sale of property, effectively receives the sales proceeds through purported loans. In a typical transaction, the seller enters into a contract to sell appreciated property to a buyer for cash and then purports to sell the same property to an intermediary in return for an installment note. The intermediary then purports to sell the property to the buyer and receives the cash purchase price. Through a series of related steps, the seller receives an amount equivalent to the sale price, less various transactional fees, in the form of a purported loan that is nonrecourse and unsecured.[10] [Emphasis added.]

Once again, in the 2023 "Dirty Dozen" list, the IRS identified monetized installment sales with a yet again subtle change (again, the emphasis is ours):

> In these *potentially abusive* transactions, promoters find taxpayers seeking to defer the recognition of gain upon the sale of appreciated property. They facilitate a purported monetized installment sale for the taxpayer in exchange for a fee. These installment sales occur when an intermediary purchases appreciated property from a seller in exchange for an installment note. The notes typically provide for payments of interest only, with principal being paid at the end of the term. In these arrangements, the seller gets the lion's share of the proceeds, but improperly delays the recognition of gain on the appreciated property until the final payment on the installment note, often years later.[11] [Emphasis added.]

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[7] The chief counsel advice factually distinguishes FAA 20123401F, a field attorney advice memorandum that some participants rely on as authority for the tax treatment claimed in a monetized installment sale. In FAA 20123401F, the taxpayer was entitled to the favorable installment method treatment under section 453. That transaction is distinguishable, according to ECC 202118016, because it involved farm property (to which the pledging rule of section 453A(d) does not apply) and did not involve an intermediary. One could expect the IRS to reiterate this distinction in an audit or other challenge to a monetized installment sale transaction.

[8] IR-2021-144.

[9] *See* IR-2022-113; IRS Tax Tip 2022-99; IR 2023-65; IR 2023-71; and IRS Tax Tip 2023-57.

[10] IR 2022-113.

[11] IR 2023-65.

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Notably, the IRS has been inconsistent in describing these transactions on the "Dirty Dozen" list. They were first labeled "improper," which then evolved into the transactions involving the "inappropriate" use of the installment sale rules. The most recent iteration, on April 5, 2023, refers to monetized installment sale transactions as only "potentially" abusive.[12] It would be easy enough for the IRS to copy the description from one iteration of the list to the next, so this would seem intentional. We don't want to read too much into that watered down language, and taxpayers probably shouldn't either, but at a minimum, the final description of the transaction (before issuing the proposed regulation) as only "potentially abusive" would arguably make it reasonable for a taxpayer to believe that his transaction, or an adviser's version of the transaction, was *not* abusive.

The "Dirty Dozen" is a powerful IRS communication tool. We suspect that many taxpayers who were considering entering into a monetized installment sale transaction may have changed their minds once the transaction started appearing on the list. To state the obvious, nobody likes to be audited, and the transaction's inclusion on the "Dirty Dozen" list would suggest it is likely that the IRS will spend some of its enforcement resources auditing these transactions. But what about taxpayers who have already engaged in the transaction? Many are certainly watching the clock, wondering if the IRS will get to them before their statutes of limitation expire.

Listed Transaction Status

The statute of limitations is one reason why the IRS's listing monetized installment sale transactions is critical to a taxpayer's strategy. Once the IRS finalizes regulations listing the transaction, its time to assess additional tax may be unilaterally extended.

Now that Treasury has issued proposed regulations, and assuming they are eventually finalized, participants in monetized installment sales will have no choice but to disclose the transaction to the IRS, unless their statute of limitations for all affected tax years is closed, lest they risk significant escalated penalties. More specifically, taxpayers will have to disclose the transaction *and* any "substantially similar" transaction. The phrase "substantially similar" is extremely broad in the context of the disclosure of listed transactions, encompassing any transaction expected to obtain the same or similar tax consequences, which is either factually similar or based on a strategy the same as or similar to the one described in the listing notice — and broadly construed in favor of disclosure.

The proposed regulations describe the monetized installment sale as a transaction that includes the following elements:

> (1) A taxpayer (seller), or a person acting on the seller's behalf, identifies a potential buyer for appreciated property (gain property), who is willing to purchase the gain property for cash or other property (buyer cash).
>
> (2) The seller enters into an agreement to sell the gain property to a person other than the buyer (intermediary) in exchange for an installment obligation.
>
> (3) The seller purportedly transfers the gain property to the intermediary, although the intermediary either never takes title to the gain property or takes title only briefly before transferring it to the buyer.
>
> (4) The intermediary purportedly transfers the gain property to the buyer in a sale of the gain property in exchange for the buyer cash.
>
> (5) The seller obtains a loan, the terms of which are such that the amount of the intermediary's purported interest payments on the installment obligation correspond to the amount of the seller's purported interest payments on the loan during the period. On each of the installment obligation and loan, only interest is due over identical periods, with balloon payments of all or a substantial portion of principal due at or near the end of the instruments' terms.
>
> (6) The sales proceeds from the buyer received by the intermediary, reduced by

[12] IR-2023-71.

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> certain fees (including an amount set aside to fund purported interest payments on the purported installment obligation), are provided to the purported lender to fund the purported loan to the seller or transferred to an escrow or investment account of which the purported lender is a beneficiary. The lender agrees to repay these amounts to the intermediary over the course of the term of the installment obligation.
>
> (7) On the seller's Federal income tax return for the taxable year of the purported installment sale, the seller treats the purported installment sale as an installment sale under section 453.

The proposed regulations also provide that a transaction may be substantially similar to the transaction described above even if it does not include all the listed elements. The proposed regulations explain, for example:

> A transaction would be substantially similar to a monetized installment sale if a seller transfers property to an intermediary for an installment obligation, the intermediary simultaneously or after a brief period transfers the property to a previously identified buyer for cash or other property, and in connection with the transaction, the seller receives a loan for which the cash or property from the buyer serves indirectly as collateral.

Disclosure is typically required on Form 8886, "Reportable Transaction Disclosure." For years preceding the publication of the final regulations, if a return has already been filed and the statute of limitations is still open, the taxpayer will have to fill out Form 8886 and file it with the Office of Tax Shelter Analysis. For future years and future transactions, the taxpayer will have to file the form with her tax return and also mail a copy to that office.

While having to file a disclosure statement leads to more time and expense in preparing tax returns, someone who has engaged in a monetized installment sale has even more skin in the game because the IRS will likely audit the transaction. The regulations, when finalized, will give the IRS more time to do so. Critically, if a taxpayer's statute of limitations for any period is still open when this becomes a listed transaction, the taxpayer will have to report the transaction to the IRS, and the IRS will have one year from that date to assess any tax regarding the transaction (unless a material adviser provides the information to the IRS on an earlier date).

Whether a taxpayer's statute of limitations is still open depends on the circumstances. The statute of limitations could be three years, six years, or forever, depending on whether the taxpayer filed all required forms, whether the IRS asserts fraud, and whether the taxpayer adequately disclosed the transaction on a return if the transaction caused the taxpayer to omit more than 25 percent of gross income.

IRS Arguments

One thing that "listing" a transaction does *not* do is provide certainty about the appropriate tax treatment. Instead, it reflects the IRS's determination that a transaction is abusive. The courts may or may not agree with the IRS, and the actual tax treatment would depend on the facts of each case. The IRS supported its determination, however, with a lengthy explanation of the reasons *why* it believes the transaction to be abusive and the arguments it intends to make, some of which seem to have evolved from the 2019 chief counsel advice but others of which are new.

The IRS's first argument is "the intermediary is not a bona fide purchaser of the gain property that is the subject of the purported installment sale." The preamble explains that from the seller's perspective, "the sole economic effect of entering the monetized installment sale transaction . . . is to pay direct and indirect fees to the intermediary and the purported lender in an amount that is substantially less than the Federal tax savings purportedly achieved from using section 453 to defer the realized gain on the sale."

The preamble then cites various authorities for the proposition that when "an intermediate transaction with a third party is interposed and lacks independent substantive (non-tax) purpose," it is not respected for federal income tax purposes and is appropriately treated as a sale of the property by the seller directly to the buyer

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in the tax year in which the seller transfers the gain property. The proposed regulations augment this by also arguing that the intermediary cannot be treated as the owner of the property because it does not have the benefits and burdens of ownership.

The IRS's second argument is that the seller should be treated as having already received the full payment at the time of the sale to the buyer. The preamble cites three reasons:

> (1) the purported installment obligation received by the seller is treated as the receipt of a payment by the seller under [reg.] section 15a.453-1(b)(3) since it is indirectly secured by the sales proceeds, or (2) the proceeds of the purported loan are appropriately treated as a payment to the seller because the purported loan is not a bona fide loan for Federal income tax purposes, or (3) the pledging rule of section 453A(d) deems the seller to receive full payment on the purported installment obligation in the year the seller receives the loan proceeds.

Perhaps most notably, the IRS's third argument is that "the transaction may be disregarded or recharacterized under the economic substance rules codified under section 7701(o) or the substance over form doctrine." That argument is particularly notable because the IRS has rarely relied on section 7701(o), although that seems to be changing in more recent years. The section 7701(o) argument raises the stakes because the reasonable cause defense that normally applies to accuracy-related penalties does not apply to transactions determined to lack economic substance under section 7701(o), essentially making the penalty automatic if the transaction lacks economic substance. Finally, the preamble concludes the IRS's arguments by indicating that the step transaction doctrine and conduit theory may also apply to recharacterize monetized installment sale transactions.

Penalties for Taxpayers

Listing of the monetized installment sale transaction may result in stiff penalties for some taxpayers.

Failure to disclose a transaction results in a penalty of 75 percent of the decrease in tax shown on the return as a result of the reportable transaction (with a minimum amount of $5,000 for natural persons and $10,000 for other cases, and a maximum amount of $100,000 for natural persons and $200,000 for other cases).[13]

The tax code also imposes a 20 percent accuracy-related penalty on any understatement attributable to a listed transaction (the actual computation is complicated). Moreover, if a taxpayer is required to disclose a listed transaction but fails to do so, the penalty rate jumps to 30 percent of the understatement.[14] In addition to reiterating the attacks the IRS originally proposed in the 2019 chief counsel email, the proposed regulations add that the IRS intends to attempt to disregard or recharacterize the transactions under the codified economic substance doctrine rules of section 7701(o), which would give rise to a 40 percent penalty under section 6662(i) if the taxpayer does not disclose the transaction.

And those are just the penalties specific to listed transactions. The IRS can pursue other, more general penalties, such as negligence, substantial understatement, or civil fraud (although the IRS cannot "stack" most penalties).

What Taxpayers Should Do Now

Taxpayers should consider whether they want to stand by their position before the IRS finalizes the proposed regulations and gets moving with audits, because taxpayers may have options now that they won't have later.

History tells us the IRS will audit most, if not all, taxpayers who engage in a listed transaction. This makes perfect sense from the agency's perspective — if a disclosure tells the IRS that a taxpayer has engaged in a transaction that the IRS has publicly determined is abusive, the IRS has significant incentive to audit the transaction.

Audits seem even more likely given the recent increases in IRS funding under the Inflation Reduction Act, because there should be plenty of resources at the IRS's disposal with which to

[13] Section 6707A(b).

[14] Section 6662A(c).

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pursue these taxpayers and their advisers. Moreover, the IRS has already indicated in its strategic operating plan for that funding that it intends to "focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap" while also delivering "cutting-edge technology, data, and analytics to operate more efficient[ly]."[15] Mining disclosure forms from monetized installment sale transactions — and other listed transactions — directly aligns with those goals and priorities.

If the taxpayer is not yet under audit, she may have the option of filing a qualified amended return. If she is eligible to file such a return, the taxpayer can effectively reverse the transaction and avoid most civil penalties. Eligibility depends on various timing rules, so taxpayers who want to consider this option should speak with their tax advisers, and quickly — there is no telling when the IRS will take action that could negate this option.

Deciding whether to ride it out or file an amended return involves several considerations, such as:

1. How strong is the reporting position?
2. How strong is the taxpayer's penalty defense if the transaction is ultimately disallowed? Was a legal opinion secured?
3. How much time does the IRS have left to open an audit? Will the statute of limitations expire before the IRS could plausibly finalize the regulations?
4. What is the taxpayer's comfort level? Is she sleeping at night?
5. How much tax is at issue? What is the possible penalty?
6. What did the taxpayer do with the tax savings?

As to the first consideration, it is impossible to opine on the substantive positions of the various permutations of the monetized installment sale without seeing the nuts and bolts of the individual transactions. Regarding the second factor, however, it seems that the fact that the IRS publicly stated *this year* that the transaction was merely "potentially" abusive would be helpful to a penalty defense, especially if the taxpayer received other, independent tax advice. On the other hand, as explained above, the IRS's indication that it will assert that the transactions lack economic substance makes the penalty analysis more complicated, given the strict liability nature of that penalty.

Deciding what action to take requires a thorough examination by someone experienced in IRS matters. Any taxpayer or adviser who has engaged in a monetized installment sale transaction should speak with their tax adviser about their options now that IRS enforcement is increasing. ■

[15] Released April 6, 2023. *See* IR-2023-72.

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