

Structured Installment Sales vs. Monetized Installment Sales

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Reprinted from *Tax Notes Federal*, December 23, 2024, p. 2367

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In this article, Luecke and Hindert seek to provoke discussion about the differences between properly executed structured installment sales and monetized installment sales, positing that the former are legitimate transactions while the latter are not.

Although the authors received input on key aspects of this article from seasoned tax attorneys, all matters expressed here solely represent the personal views of the authors in their individual capacities and do not reflect those of any other person or institution.

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I. Introduction

Some market participants mistakenly confuse properly structured installment sales with monetized installment sales. Thus, this article posits that there are meaningful differences between such types of transactions and,

accordingly, that properly executed structured installment sales represent a valid and useful way to facilitate purchase and sale transactions between bona fide buyers and sellers of qualifying capital assets. This article does so by, among other things, analyzing the Treasury Department's notice of proposed rulemaking (NPRM) dated August 3, 2023.¹

The NPRM proposes additional regulations under section 6011 that would cause the IRS to deem some transactions as, or "substantially similar" to, monetized installment sales. These transactions would be designated as listed transactions, resulting in ineligibility for federal tax treatment under section 453; heightened reporting requirements;² and potential penalties imposed by the IRS on participants and their advisers if the delineated reporting requirements are not satisfied.³

Since the expiration of the public comment period on September 28, 2023, during which five parties submitted comments, Treasury has not made any more announcements about the NPRM. In the meantime, it is worthwhile to distinguish between properly executed structured installment

¹REG-109348-22.

²The proposed regulations would require material advisers to disclose those transactions and maintain lists regarding monetized installment sale transactions in accordance with sections 6111 and 6112.

³Taxpayers and material advisers who are required but fail to disclose such transactions or file incomplete or false disclosure statements would be subject to penalties under section 6707A.

sales and monetized installment sales by reference to and analysis of the NPRM (recognizing that any updates from Treasury or announcement of final regulations could affect the analyses).

The NPRM is helpful in that it distinguishes traditional installment sales, which qualify for federal tax treatment under section 453, from monetized installment sales (and substantially similar transactions) which do not. In doing so, Treasury describes in detail the characteristics of transactions that are of most concern to the IRS and offers valuable insights that help clarify gray areas in preexisting legal and market precedents.

Many of the observations in this article share some similarities with some of the comments submitted during the comment period, and we agree that the proposed rules and commentary as currently written in the NPRM would benefit from some express revisions and clarifications by the Treasury itself.

This article seeks to provide thoughts and observations regarding the following questions:

- What is a structured installment sale?
- What is a monetized installment sale or a substantially similar transaction?
- Is a properly executed structured installment sale a monetized installment sale or a substantially similar transaction?

II. What Is a Structured Installment Sale?

In order to understand what structured installment sales are, it is helpful to first discuss the sources from which they originated: traditional installment sales and structured settlements.

A. Traditional Installment Sales

1. Overview.

Section 453(b)(1) defines an installment sale as “a disposition of property for which at least one payment is to be received after the close of the taxable year of the disposition.” This article refers to those installment sales as traditional installment sales to distinguish them from structured installment sales and monetized installment sales. The most common assets that qualify for section 453 treatment are real estate and businesses. Farm-related installment sales

can benefit from some tax exemptions that are unavailable for other capital assets.⁴ IRS Publication 537 identifies other assets (such as publicly tradable securities) that are ineligible for section 453 treatment.⁵

In a traditional installment sale, the buyer of a qualifying capital asset pays the purchase price to the seller in the form of installment payments over an agreed-upon period of years instead of the full purchase price in cash at closing. In essence, in a traditional installment sale, the parties are agreeing to a promissory note with the seller providing seller financing. That is true even if no actual promissory note is executed by the parties. Most often, however, a traditional installment sale is likely to involve a separate promissory note document along with an installment sale agreement, and the seller will often obtain a security interest in the qualifying asset being sold.

A transaction can either be fully or partially in the form of an installment sale. A full installment sale is one in which the entire purchase price is payable by the buyer to the seller solely in the form of installment payments, while a partial installment sale is one in which some of the purchase price is payable in the form of cash and some is payable in the form of installment payments.

2. Taxation.

The opportunity to defer capital gains taxation represents an important reason why many sellers prefer traditional installment sales compared with all-cash sales. Only the installment portion of a transaction is eligible for section 453 treatment, however, meaning that the seller is able to defer capital gains taxes into future years only on the installment portion but would

⁴For example, under section 453, the installment sale rules generally do not apply to inventory or property that is sold in the ordinary course of business. However, if a farm is selling capital assets, such as livestock held for draft, breeding, or dairy purposes, these assets can qualify for installment sale treatment. Section 453(l)(2)(A) defines the eligibility of “farm property” for installment sale treatment, which includes assets used in a farming business that are held for draft, breeding, or dairy purposes and qualify as capital assets under section 1231(b). Another difference under section 453A relates to the special interest charge imposed on the deferred tax liability for some high-dollar installment sales. Farmers can receive exemptions from any interest charge in some circumstances. For example, the portion of a sale attributable to a personal residence is exempt under section 453A(b)(3)(A) and farm-related sales to related parties can be exempt under section 453A(b)(3)(B).

⁵See Publication 537, “Installment Sales” (2022).

have to pay capital gains taxes in the year of closing on any cash received at closing.⁶ Because the seller in a traditional installment sale must wait to receive each installment payment, traditional installment sales typically include an interest component to compensate the seller for the time value of money. The seller must pay ordinary income taxes on the interest portion of each installment payment in the year received.

Other taxes might apply to an installment sale, including net investment income tax if the seller is a high-income taxpayer;⁷ state and local taxes;⁸ recapture of investment tax credit if the sale involves an asset subject to an investment tax credit;⁹ alternative minimum tax if the seller has previously taken depreciation deductions or has a complex overall tax situation;¹⁰ and some interest charges if the installment obligation exceeds \$5 million (\$10 million if married).¹¹ Also, capital gains taxes must be immediately recognized if an installment obligation is distributed, transmitted, sold, or otherwise disposed of.¹²

3. Purposes.

In addition to deferring capital gains taxes, a traditional installment sale can serve many nontax purposes for buyers and sellers as compared with an all-cash sale. Such purposes involve enhanced cash flow management, affordability, and marketability. For a more specific example, with a traditional installment sale, a buyer can avoid having to make a large upfront payment for the full purchase price. Also, a buyer can avoid the process of obtaining a loan from a bank (or being unable to obtain one). Also, a traditional installment sale enables both parties to tailor the future payments based on their financial needs.

For a seller, a traditional installment sale can provide a return in the form of interest, enabling

the seller to avoid having to find a new investment for cash proceeds from an all-cash sale. Further, a traditional installment sale could, in some circumstances, increase the probability of reaching a clearing price based on the relative benefits and burdens to each of the parties of an installment versus an all-cash sale. Overall, the availability and use of a traditional installment sale can facilitate transactions that might not otherwise occur.

B. Structured Settlements

1. Historical context.

In addition to its direct statutory linkage to traditional installment sales, the structured installment sale concept has an historical relationship with structured settlements.¹³ Congress created and authorized structured settlements in 1982 when it amended section 104 and enacted section 130.¹⁴ Based on that legislation, life insurance companies, assignment companies,¹⁵ and annuities have been used to provide tax-efficient solutions for personal injury settlements payable in the form of future payments. Later, market participants began to deploy the same basic concepts to create structured installment sales because, like structured settlements, the underlying installment sale obligation originates from the tax code (that is, section 453) and involves future payments.

2. Similarities and differences.

Like a structured (and traditional) installment sale, a structured settlement begins with a foundational agreement between parties that provides for all or part of the consideration to be paid in the form of future payments. The foundational agreement in a structured settlement is a settlement agreement as compared

⁶ Section 543(c).

⁷ Section 1411.

⁸ California, for example, taxes capital gains as regular income, so the tax rate for individuals can be as high as 13.3 percent and for corporations as high as 8.84 percent.

⁹ Section 50.

¹⁰ Section 55.

¹¹ Section 453A.

¹² Section 453B(a).

¹³ "A structured settlement is a negotiated financial or insurance arrangement through which a claimant agrees to resolve a personal injury tort claim by receiving part or all of a settlement in the form of periodic payments on an agreed schedule, rather than as a lump sum." Wikipedia, "Structured Settlement" (Oct. 28, 2024).

¹⁴ The Periodic Payment Settlement Act of 1982, P.L. 97-473, section 101(a).

¹⁵ Section 130 places no restrictions on who may serve as an assignee, nor does it designate any regulatory authority for assignees. Assignees used in structured settlements and structured installment sales generally are corporations and therefore are referred to as "assignment companies" in this article.

with a purchase and sale agreement in a structured (and traditional) installment sale. The parties in a structured settlement are defendants and plaintiffs, while the parties in a structured (and traditional) installment sale are buyers and sellers. The consideration in a structured settlement includes the portion of the settlement amount payable in future periodic payments while, in a structured (and traditional) installment sale, the consideration includes the portion of the purchase price payable in future installment payments.

In a qualified structured settlement, the defendant assigns (in accordance with statutory language in section 130) its periodic payment obligation to an assignment company in exchange for a lump sum payment from the defendant to the assignment company. Similarly, the buyer in a structured installment sale delegates (in accordance with definitions in the *Restatement of the Law*)¹⁶ its installment obligation to an assignment company in exchange for a lump sum payment from the buyer to the assignment company.

In both a structured settlement and a structured installment sale, the assignment agreement prohibits the recipient of the future payments from accelerating, deferring, increasing, decreasing such payments (for purposes of this article, any such or similar action is referred to as a modification)¹⁷ or selling, assigning, pledging, hypothecating, or otherwise transferring or encumbering such payments (for purposes of this article, any such or similar action is referred to as a transfer),¹⁸ except in limited

circumstances;¹⁹ the assignment company uses the consideration it receives (net of a service fee) to acquire an asset (a funding asset) that enables the assignment company to conveniently fund the future “periodic” or “installment” payments that were assigned or delegated to it, as applicable; the funding asset is typically an annuity issued by a regulated and rated life insurer; the assignment company is the sole owner of the annuity; the annuity payments match the periodic or installment payments in amount and timing; and the assignment company instructs the life insurer, for administrative convenience, to send the annuity payments directly to the plaintiff or the seller.

Noteworthy nuances in taxation and liability appear when comparing structured settlements and structured installment sales. Regarding taxation, the periodic payments in a structured settlement may be either excluded or deferred (depending on the type of damages) by the payee from all federal income tax, while the installment payments in a properly executed structured installment sale may only be deferred by the seller from capital gains taxation.

Regarding liability, the defendant in a structured settlement generally receives a full and final release from all future liability related to the claim including the periodic payments on entering into the applicable settlement and assignment agreements, whereas the buyer in a structured installment sale receives no such release on entering into the applicable delegation agreement.²⁰

¹⁶ Restatement (Second) of Contracts, section 318 (1981).

¹⁷ Section 130(c)(2)(B).

¹⁸ See, e.g., Rev. Rul. 2003-115, 2003-2 C.B. 1052 (periodic payments made to a claimant of the September 11th Victim Compensation Fund in accordance with an award determination agreement among the claimant, the special master administering the fund, and an assignment company excludable from the claimant’s gross income under sections 104(a)(2) and 139(f); award determination agreement included a section 130 assignment of the periodic payment obligation and provided that “no payee or beneficiary shall have the right or power to transfer, mortgage, encumber or anticipate the periodic payments, by assignment or otherwise”).

¹⁹ For example, in the case of structured settlements, the National Structured Settlement Trade Association Model Qualified Assignment and Release Agreement allows for transfers that meet the exception to the section 5891 excise tax. Section 5891 imposes a 40-percent excise tax on any person who acquires structured settlement payment rights in a factoring transaction unless the transfer is approved in advance in a qualified order issued under an applicable state statute by an applicable state court. Section 5891 also provides rules to determine the applicable state statute and the applicable state court as well as the factual and legal findings required in a qualified order.

²⁰ Under basic contract law, in a structured settlement the release from liability is the actual consideration to the defendant in the underlying settlement agreement, whereas the comparable consideration to the buyer in a structured installment sale is the qualifying asset that the buyer takes title to.

C. Structured Installment Sales

1. Typical Characteristics.

This article posits that a properly executed structured installment sale would (or should) generally include the following characteristics:

1. a bona fide buyer and seller enter into a purchase and sale agreement of a qualifying capital asset;
2. all or some of the purchase price is payable in installments beyond the year of closing;
3. the installment payments cannot be modified or transferred (as defined earlier);
4. title to the asset transfers directly from the bona fide seller to the bona fide buyer at closing;
5. the buyer delegates its future payment obligation to an assignment company in exchange for cash consideration equal to the face amount of the underlying installment obligation;
6. the assignment company uses funds received (net of fees) to purchase a funding asset (for example, typically an annuity);
7. the annuity payments, payable to the assignment company as owner, correspond to the installment payments;
8. the annuity payments cannot be modified or transferred (as defined above);
9. the assignment company instructs (for convenience) the life insurer to send payments directly to the seller; and
10. the purchase and sale agreement between the seller and buyer remains in full force and effect until the final installment payment is made.

2. Nontax purposes.

In addition to the nontax purposes of a traditional installment sale discussed above, a structured installment sale enhances a traditional installment sale through further nontax purposes. For example, a structured installment sale can expand a buyer's purchase opportunities or increase the buyer's chances of becoming a seller's preferred counterparty by offering enhanced flexibility and security relative to a traditional installment sale. With a structured installment sale, a buyer also benefits from the administrative

convenience of the assignment company or the life insurer making the future payments.

As it relates to a seller, the use of a structured installment sale can provide greater customization of installment payments than can be achieved in a traditional installment sale because of the involvement of institutional parties. Because payments in a structured installment sale typically are backed by a rated and regulated life insurer, a structured installment sale also provides a seller with greater security and transparency than a traditional installment sale.

Further, a structured installment sale enables both parties to avoid having to negotiate an interest rate because the funding asset (an annuity, for example) determines the market rate of return to the seller. Similarly, both parties can derive benefit from the asset-liability expertise, or the use of innovative products, of a life insurer.

Similar to how structured settlements facilitate personal injury negotiations, structured installment sales can facilitate the purchase and sale of qualifying assets by helping the parties reach a clearing price (whether lower for the buyer or higher for the seller) that might not have been otherwise achievable. In doing so, structured installment sales can help integrate important decisions about the purchase and sale of qualifying capital assets into overall financial, retirement, and estate planning endeavors.

III. What Is a Monetized Installment Sale or a Substantially Similar Transaction?

This article posits that there are four substantive areas of the NPRM that discuss the types of transactions the IRS would deem to be monetized installment sales or substantially similar transactions. First, the NPRM describes 11 characteristics of transactions known by the IRS to be marketed by promoters.²¹ Second, the NPRM sets out three arguments that the IRS "intends to use to challenge the reported treatment of these transactions as installment sales."²² Third, the

²¹ See REG-109348-22, at 9 and 10.

²² See *id.* at 10-13.

NPRM delineates seven specific elements that define monetized installment sales.²³ Fourth, the NPRM provides a three-part example of transactions that the IRS would deem substantially similar to monetized installment sales.²⁴

A. The 11 Characteristics

The NPRM states that the IRS is aware of transactions by promoters that purport to convert cash sales into installment sales, describing those transactions as having the following 11 characteristics:

1. a seller identifies a buyer to purchase its property;
2. the seller sells the property to an intermediary (who might be the promoter);
3. the intermediary issues a note to the seller requiring annual interest payments and a balloon payment at maturity representing the principal amount;
4. the intermediary immediately, or shortly after, transfers the property to the buyer for cash in a purported sale, completing the prearranged sale;
5. the promoter refers the seller to a third party that enters into a purported loan agreement with the seller;
6. the intermediary generally transfers the amount received from the buyer, less fees, to an account held by or for the benefit of the third party;
7. the third party provides a purported nonrecourse loan to the seller in an amount equal to what the seller would have received from the buyer, less some fees;
8. the loan is funded, or collateralized, by the amount deposited into the account;
9. the seller's obligation to make payments on the purported loan is typically limited to the amount to be received by the seller from the intermediary under the purported installment obligation;

²³ See *id.* at 14 and 15.

²⁴ See *id.* at 15 and 16.

10. the purported installment obligation, note, and loan offset each other and terminate at maturity, resulting in a deemed payment on the purported installment obligation and triggering taxable gain to the seller purportedly deferred until that time; and
11. the promotional materials assert that the seller can defer gain under section 453 until receipt of balloon payment at note maturity, despite the seller's receiving cash from the lender at or shortly after closing.

B. The Three Arguments

The NPRM states that "the IRS intends to use multiple arguments to challenge the reported treatment of these transactions . . . , including the arguments described below":

1. the intermediary is not a bona fide purchaser;
2. the seller is appropriately treated as receiving full payment at sale because the purported installment obligation is indirectly secured by sale proceeds; or the purported loan is not a bona fide loan; or the seller is deemed (in accordance with the pledging rule) to receive full payment on the purported installment obligation in the year of receipt of loan proceeds; and
3. the transaction may be disregarded or recharacterized under the economic substance rules codified under section 7701(o) or the substance-over-form doctrine (or the step transaction doctrine or conduit theory).

The third item above is a catchall that allows the IRS to challenge transactions in which the first and second items are not present.

C. The Seven Elements

The NPRM goes on to state that any transaction involving the following seven elements is defined as a monetized installment sale:

1. a seller or its agent identifies a buyer to purchase the seller's appreciated property;
2. the seller agrees to sell the property to an intermediary for an installment obligation;

3. the seller purports to transfer (or only briefly transfers) the property to the intermediary;
4. the intermediary purports to transfer the property to the buyer for cash from the buyer;
5. the seller obtains a loan from a third-party lender;
6. the intermediary pays (or makes available as collateral for the loan) the buyer's proceeds to the lender, and the lender agrees to repay the intermediary over the installment term; and
7. the seller treats the transaction as an installment sale on its tax return.

D. The Three-Part Example

The NPRM further provides that a transaction does not have to include all seven elements to be considered substantially similar to, and therefore subject to the same requirements as, a monetized installment sale. According to the NPRM, a substantially similar transaction is one that is “expected to obtain the same or similar types of tax consequences and is either factually similar or based on the same or similar tax strategy” as a monetized installment sale.²⁵ The NPRM then provides the following three-part example of a substantially similar transaction:

1. the seller transfers property to an intermediary in exchange for an installment obligation;
2. the intermediary simultaneously (or briefly after) transfers the property to a previously identified buyer for cash or other property; and
3. the seller receives a loan for which the cash or property serves indirectly as collateral.

We conducted an analysis of the areas of overlap across the four substantive areas of the NPRM discussed above. This overlap analysis suggests that the IRS has two main concerns: (1) the nature, purpose, and role of the intermediary (for example, being a promoter, purporting to take title, being involved in a loan to the seller, and serving no discernable purpose except tax avoidance) and (2) the seller's receipt of cash from

a loan directly or indirectly connected to the specific transaction. Therefore, it appears that, in any actual transaction that lacks all seven elements, the presence of those two main concerns is the crux of assessing whether the transaction is substantially similar to a monetized installment sale.

IV. Structured Installment Sale: Monetized or Substantially Similar?

In a properly executed structured installment sale there are many legitimate, nontax purposes for both buyers and sellers; there are no loans or liquid collateral provided to, or for the benefit of, the sellers in any way; the sellers receive no payments (in amount and timing) beyond those provided for in the installment obligations between the sellers and buyers; the payments cannot be modified or transferred; the assignment company is the sole owner of the funding asset (for example, an annuity); the funding asset payments (for example, annuity payments), just like the installment payments, cannot be modified or transferred; and all rights and obligations of the parties in the underlying installment obligation remain in full force and effect until the last installment payment is made.

Thus, mapping the characteristics of a properly executed structured installment sale against the four substantive areas of the NPRM summarized above supports the notion that a properly executed structured installment sale is not a monetized installment sale or substantially similar to one. That said, to reliably determine whether any actual transaction might be considered a monetized installment sale (or substantially similar to one), the specifics of the transaction should be:

- mapped against the four substantive areas of the NPRM (with due emphasis on the two main concerns identified by the overlap analysis as discussed above);
- considered in light of all other aspects of the NPRM;
- evaluated against all other legal and regulatory precedents (it being suggested, however, that the NPRM is the most recent and thus should be given the most weight relative to precedents);

²⁵ See *id.* at 14.

- assessed relative to any accepted, long-standing, and unchallenged market practices as well as any challenged market practices;
- thoroughly reviewed against the specific provisions of the transaction's definitive documentation; and
- commenced with the advice of qualified legal and tax advisers.

V. Conclusion

The NPRM describes traditional installment sales, discusses in detail the types of transactions of concern to the IRS, defines monetized installment sales, and provides guidance regarding transactions that could be deemed substantially similar to monetized installment sales. In so doing, the NPRM offers valuable insights into the meaningful differences between properly executed structured installment sales and monetized installment sales.

We posit that the IRS is primarily concerned with transactions that involve intermediaries that serve no purpose other than tax avoidance and sellers that receive the full value of a sale at or soon after closing under the guise of an installment sale in an attempt to inappropriately defer taxes over time. Thus, the IRS considers such transactions tax avoidance schemes, requiring full taxation to the sellers in the year in which the transactions take place and potentially imposing penalties against sellers (and advisers) if they fail to satisfy the increased reporting requirements applicable to the transactions.

In contrast, sellers in properly executed structured installment sales (just like in traditional installment sales) receive only the payments over time that they and the bona fide buyers in the underlying installment obligation bargained for. Thus, this article posits that sellers in properly executed structured installment sales should be permitted to pay taxes over time (just like in traditional installment sales). Although each transaction must be thoroughly evaluated based on its specific details, we believe the NPRM supports the proposition that a properly executed structured installment sale remains a valid and useful way to facilitate bona fide transactions between bona fide sellers and buyers of qualifying capital assets.

As noted, the general nature of the “substantially similar” definition and the catch-all aspects of some areas of the NPRM could be interpreted to cast too wide of a net with the potential effect of stifling some legitimate transactions. Thus, the marketplace could benefit from express revisions to the proposed regulations or the commentary in the NPRM that would, for example, incorporate key aspects of the three-part example or the two main concerns directly into the definition of substantially similar. Regardless, even absent any express revisions, we reiterate that the four substantive areas of the NPRM offer valuable insights into distinguishing between legitimate and illegitimate transactions.

This article is intended to help readers interpret the NPRM as published and glean insights from it, and may need to be updated on any further announcement from Treasury.²⁶ ■

²⁶ This article is general and educational in nature and purpose; is not applicable to any specific transaction; is not intended to be and should not be construed to be, or used or relied on in any way as, tax or legal advice; represents solely the personal thoughts of the authors; and is designed to provoke discussion on the matters herein. The authors make no representation or warranty as to the accuracy or completeness of any aspect of this article. Any party interested in pursuing, or involved in, any specific transaction should obtain tax and legal advice based on the details of such transaction.

Although Luecke currently serves as president and chief strategy officer of Independent Insurance Group LLC (IIG) and chief operating officer of Independent Life Insurance Company and Hindert currently serves as vice president, new business development for IIG and its subsidiaries, this article is written in their individual and not company capacities. Luecke and Hindert, while they are attorneys and practiced law in their past, are not tax attorneys.