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The Installment Method for Retailers

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An "installment plan" sale is any sale of real or personal property in which parts of the selling price are payable at stated intervals. The transaction may take the form of a conditional sale, a sale with purchase money mortgage, etc., and it is immaterial when title passes. Profits from lease-purchase arrangements treated as sales for tax purposes under Revenue Ruling 55-540[1] may be reported on the installment method.

Installment paper may be interest-bearing (written for the amount of the sales price but requiring the payment of interest), it may take the form of discount paper (in which a charge for the use of the money is included in the face amount of the instrument), or it may be for the sale price only with no provision for interest or discount. In the case of discount paper the total amount of the installment obligation includes a charge for delayed payments as well as the seller's usual gross profit from the sale.

The installment method of accounting is authorized by Section 453 of the Internal Revenue Code. Section 453(a) permits a dealer in personal property (a person who regularly sells personal property on the installment plan) to return as income from installment sales in any taxable year that proportion of the installment payments actually received in such year determined by the ratio of the gross profit to the total contract price. Section 453(b) permits similar treatment for sales of real estate and for casual sales of personal property for a price exceeding $1,000, provided payments in the year of sale do not exceed 30 per cent of the selling price.

A change from the accrual basis to the installment basis is governed by Section 453(c). If a taxpayer elects for any taxable year to report his taxable income on the installment basis, then in computing his taxable income for such year (or for any subsequent year) installment payments actually received during the year for sales made prior to the year of change shall *not* be excluded, but the tax is to be reduced by an "adjustment," which is the tax attributable to the item

[1] Rev Rul 55-540 (CB 1955-2, 39).

in the prior year (on the accrual basis), but not in excess of the tax attributable to the item in the year in which it is includable a second time. I shall discuss this reduction a little later.

Gains and losses on disposition of installment obligations are covered by Section 453(d). In addition to the general rule this subsection contains special rules for transmission at death, for certain liquidations, and for life insurance companies. For the purpose of this discussion the rule is that gain or loss shall result to the extent of the difference between the basis of an installment obligation and the amount realized from its sale. The basis of an installment obligation is the excess of its face value over the income that would be returnable were the obligation satisfied in full; in other words, as both the sale and related cost are reported in proportion to the collections made, the basis (or unrecovered cost) is the uncollected sales price minus the applicable percentage of gross profit.

Under the installment method a dealer in personal property may report the gross profit (that is, the excess of the contract price, including finance charges, over the cost of the goods sold) during one or more taxable years. The amount reported each year is determined by the proportion that installments collected during that year bears to the total contract price. For a dealer who ordinarily has substantial uncollected balances of installment receivables at the end of his taxable year, the installment method makes possible an important deferral of federal income taxes; the Wisconsin income tax law does not permit the use of the installment method by a dealer in personal property. Although my remarks are limited to retailers, you will think of similar applications for manufacturers and wholesalers.

ELIGIBILITY OF RETAIL RECEIVABLES

The first question that must be answered is whether the retailer "regularly" engages in sales on the "installment plan." This is a question of fact; some of the factors to be considered are the percentage that installment sales constitute of total sales, the number and frequency of installment sales, public knowledge that sales will be made on the installment plan, and the intention of the retailer to continue in the installment business for a substantial period of time.[2]

[2] See the following cases:
Marshall Brothers Lumber Company, 13 BTA 111
E. P. Greenwood, 34 BTA 1209
Davenport Machine and Foundry Company, 18 TC 39

The second and most important question concerning eligibility relates to the nature of the receivable. Those clearly eligible include "traditional" installment sales (conditional sales contracts, chattel mortgage notes, etc.) and those known as 60- or 90-day accounts (payable in two or three monthly installments). Ordinary 30-day accounts are, of course, not eligible, and in the "twilight zone" are those known as "revolving credit" or "budget" accounts.

Neither the Internal Revenue Code nor the Regulations specifically provide at this time whether or not income from revolving credit sales may be reported under the installment method. The attitude of the Treasury Department to date has been that sales under revolving credit plans are not eligible for the installment method.

The first and only decision up to this time relating to the tax aspects of revolving credit has been the *Consolidated Dry Goods Company* case[3] in which the District Court held that the taxpayer's "Cycle Budget Account Plan" was fairly embraced within the meaning of the words "installment plan" as used in section 453(a) of the Internal Revenue Code. The Government had argued (1) that the installment method applies only to "traditional" installment sales, (2) that payments under revolving credit plans are not identified with sales of specific articles and therefore do not qualify as installment sales, and (3) that, as some purchases could be paid for in a single installment, the taxpayer's revolving credit plan did not provide for all purchases to be paid for in installments and that this indicated the plan was not an installment plan within the meaning of section 453 of the Code. The District Court held that income from the taxpayer's revolving credit sales could be reported on the installment method because the plan retained the essential feature of an "installment plan" within the scope of section 453, i.e., "the payment by the purchaser for the merchandise sold to him in a series of periodic payments of an agreed part or installment of the debt due."

The Government did not appeal the *Consolidated Dry Goods* case, but on August 23, 1960 the Internal Revenue Service announced[4] that it will not follow the decision. The Treasury Department had previously made it known[5] that consideration is being given to the issuance of specific rules dealing with revolving credit. The Internal Revenue Service also stated in TIR 247 (its announcement that it

[3] *Consolidated Dry Goods Company,* 180 Fed. Supp. 878.
[4] See TIR 247.
[5] TD 6314 (CB 1958-2, 160).

would not follow the *Consolidated Dry Goods* case) that a study is now under way to determine whether workable standards can be formulated for determining what part of revolving credit sales qualify as sales "on the installment plan" under the statutory provisions.

It is generally believed that the Treasury Department must eventually recognize revolving-type credit accounts as being comprehended within the meaning of "installment plan." One of the problems confronting the Internal Revenue Service is the difficulty of prescribing rules that would preclude retailers from reporting substantially all income from sales on a cash basis. Some department stores apparently include all sales to each customer in a single account. The Service desires, therefore, to establish rules that would prohibit the inclusion of sales of the type ordinarily charged to "regular" charge accounts without establishing requirements that would make compliance a prohibitive task. Before the advent of the "budget" account the determination of the amount of gross profit to be deferred was comparatively simple. It was necessary only to age the installment receivables by year of sale and to apply the gross profit percentage for each of those years to the receivable balances that arose from sales in the respective years in order to determine the amounts to be deferred; this computation is also readily susceptible to audit by the Internal Revenue Service. If the customer's "budget" account includes single-payment transactions, however, as well as installment transactions, the computations (and the related audit functions) become much more involved.

Pending a determination by the Government as to an approved treatment for revolving credit accounts it appears that taxpayers would be correct in following the *Consolidated Dry Goods* case and assuming that they qualify as installment obligations, particularly in connection with election of the installment method.

CHANGING FROM THE ACCRUAL TO THE INSTALLMENT METHOD

A qualified taxpayer can change his accounting method from the accrual basis to the installment basis without obtaining the consent of the Commissioner. The election is made by attaching to the tax return for the year of change the statement required by Regulation 1.453-8, the most important part of which comprises a schedule showing the

computation of the required adjustments under the relief provisions of section 453(c)(2).

Under the 1939 Code a change to the installment method from the accrual method imposed a double tax on the income attributable to installments not yet collected at the time of the change. The same doctrine is stated in the general rule in section 453(c)(1)(A), i.e., installment payments received during the year of change or during any subsequent year are not to be excluded. A measure of relief from the double tax was provided in the 1954 Code in section 453(c)(2) in the adjustment previously mentioned. The reduction provided is the tax attributable to the item in the prior year (on the accrual basis), but not in excess of the tax attributable to the item in the year in which it is includable a second time. Section 453(c)(3) defines the tax attributable to the item as that percentage of the entire tax for the year determined by the ratio of the gross profit from installment sales to the gross income.

This formula provides incomplete relief from double taxation; in effect the relief is limited to a portion of net income from installment sales, whereas it is the gross income from such sales which is included in taxable income for a second time. It is the view of many retailers' organizations that Congress should give relief to the extent necessary to eliminate the payment of a penalty for the privilege of making an election that is provided for in the Internal Revenue Code.

The alternative to insufficient relief under section 453(c) is a sale of installment receivables at the year end of the last accrual-basis year. Such a sale has been held to prevent application of a second tax in *City Stores Co.* v. *Smith,*[6] and the Internal Revenue Service has announced in Revenue Ruling 59-343[7] that it will follow the *City Stores* decision.

If the installment obligations are transferred in valid sales, as distinguished from loans with the receivables as collateral, the taxpayer is not subject to tax on amounts collected on these accounts after the transfer. Some of the factors in determining whether a transfer is a sale or loan may be as follows:

1. Does the purchaser assume the risks of collection?
2. Are the customers notified of the sale, and, if not, is the taxpayer acting solely as agent for the purchaser in receiving further payments?

[6] *City Stores Co.,* 154 Fed. Supp. 348.
[7] CB 1959-2, 136.

3. Is the sale an "arm's-length" transaction?
4. Would the transaction be considered a sale in accordance with commercial practice and local law?

In any proposed sale of installment obligations to avoid double taxation from the change to the installment method it is advisable to obtain an advance ruling as to whether the proposed plan fulfills the requirements in accordance with Treasury Department interpretations. In view of the announcement by the Internal Revenue Service that it will not follow the *Consolidated Dry Goods* case it is extremely unlikely that any rulings issued will pass on whether revolving credit accounts qualify for the installment method. However, revolving credit accounts should be included in a contemplated sale because the Service will undoubtedly take the position that, if revolving credit accounts do qualify for the installment method, they will be subject to the double tax.

A year-end sale to avoid the double tax may reduce the bad-debt deduction for the year of the sale for a taxpayer on the reverse basis. Revenue Ruling 54-43 states: "In the computation of additions to the merchant's reserve for bad debts, any instalment accounts receivable which have been, or forthwith are to be, sold by it to the banks . . . shall not be considered." In some cases there may be a return to income of the portion of the bad-debt reserve attributable to the installment obligations. However, as the receivable balances increase from new sales under the installment method, additions to the reserve for the cost portion of the receivables are allowable.

REPORTING FOR TAX PURPOSES

The only substantial difference in reporting under the installment method as distinguished from the accrual method is the necessity for determining gross margin percentages for use in computing income applicable to installments collected. The regulations require taxpayers using the installment method to keep accounting records in such manner as to allow an accurate computation to be made of the profit realized from each year's sales. In practice the use of store-wide gross margins is generally accepted.

If the statute were literally followed, it would be necessary to determine the gross profit to be reported for the year by applying to the installment collections received the respective gross profit margins realized in the years in which the original sales were made. Or-

dinarily, however, the computation is made by determining the gross profit contained in the year-end balance of installment receivables; the receivable balances are analyzed by years of origin, and the respective gross profit margins for those years are applied to the balances to determine the amounts of gross income to be deferred for tax purposes.

The treatment of repossessed merchandise is governed by the portions of Section 453(d)(1) and (2) relating to the gain or loss resulting if an installment obligation is satisfied at other than its face value. The gain or loss on a repossession is the difference between the unrecovered cost of the goods sold and the fair market value of the goods when they are repossessed (adjusted for costs of repossession). This adjusted fair market value is the inventory value (tax basis) of the repossessed goods to the dealer. The gain or loss on repossessions that results to a dealer in personal property is subject to normal tax; the statute considers such gain or loss as resulting from sale or exchange of the property for which the installment obligation was received.

ACCOUNTING PRESENTATION

In the usual case in which the installment method is adopted for federal income tax purposes the taxpayer will retain the accrual basis in its books and financial statements. Under these circumstances the federal income taxes currently payable will not reflect the tax applicable to the gain from installment sales taken into income in the books but is deferred for tax purposes, a situation similar to that arising when one of the new depreciation methods is used for tax purposes but the straight-line method is retained in the books. The preferred practice in this situation is to charge income with a provision for federal income taxes deferred by reason of the use of the installment method, and to carry the resulting credit in the balance sheet as a noncurrent liability.

Of course it is also acceptable to adopt the installment method for book and financial report purposes. In this situation the tax provision in the income statement will be for taxes currently payable. The unrealized gross profit is classified as a deduction from installment receivables in the balance sheet.