

A Personal Experience with Installment Sales

When I was a brand-new, ready-to-be-licensed lawyer and also ready to purchase my first house, the owner of the house I chose preferred to “carry the paper”, to enjoy the benefits of an income stream from the property. He was concerned, though, about whether I would make the payments as promised.

As an indication of the times then, his way of assuring himself that I was a good risk was this: He asked only that the senior partner of the law firm which I was joining write a letter to the owner to say that I was reliable and had good prospects. I relayed the message to the senior partner, who said, “You write it, and I’ll sign it.”

I did, he did, the owner was satisfied, and I bought the house—and I really did make all of the payments! I didn’t really think of it as an installment sale, but that’s what it was.

What this story illustrates is that the installment sale which your parents and grandparents knew was often a transaction between two persons who knew and trusted each other, because of the clear risk that a seller might have to foreclose and repossess the property, if the buyer failed to pay in full.

With the widespread advent of trust deeds and varieties of kinds of third-party lending sources, installment sales faded into the



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background and ceased to be a significant part of the financing, for the purchase of either business or personal assets. Because sellers wanted to minimize foreclosure or repossession risk and because buyers wanted to be free from oversight by sellers, installment sales became a financial backwater.

My First Collateralized Installment Sale

In 1995 a rancher in Idaho contacted me for legal advice concerning an installment contract he had signed for the sale of some timber land. The rancher had expected and wanted a long-term income stream from the sale, but the buyer notified the rancher that the buyer had obtained other financing—the timber land was prime for resort development—and was about to pay the installment contract in full. The rancher asked whether there was any way to prevent the prepayment.

Upon examination of the contract I found no provision which prevented prepayment, so I asked the rancher for some time to think about what could be done.

The solution I devised was the forerunner of today’s collateralized installment sale. I arranged for another entity to assume the installment contract from the buyer. The rancher agreed to release the lien the rancher had retained on the land. The buyer paid the unpaid balance in full, but paid it to the entity which had assumed the installment contract. The cash proceeds were used to acquire mutual fund investments in the entity’s name, and the mutual-fund account made the installment payments to the rancher.

As a result, the rancher retained his desired income stream and installment reporting of the gain on sale, and the buyer obtained free and clear title and proceeded with development of the resort.

The Essence of a Collateralized Installment Sale

A collateralized installment sale is simply an installment sale in which the collateral or security for the unpaid purchase price is something other than the property or asset which is being sold.

Without their having been explicitly called “collateralized” installment sales, such sales have existed for a long time, maybe throughout history, as sellers and buyers have negotiated with each other over what collateral the buyers could provide, beyond or separate from the asset being sold.

It was that realization that made me realize that an installment sale is simply a sale with time payments of the purchase price. What the security for the unpaid purchase price is, or even whether there is any security at all, has nothing to do with whether the sale is an installment sale. It was only common practice, and nothing inherent in an installment sale, which caused the asset being sold to be the *default*—but not the necessary—security for the unpaid purchase price

“The Stan Crow Section” of the Tax Code

With that realization, I re-read the tax code. To my great satisfaction, I found that the meaning of an installment sale is, indeed, related only to whether payments are received over time.

Further, I found that Congress had actually thought about the situation of a dealer, and explicitly retained installment reporting for sales *to* dealers. Here’s the statute, for you to read for yourself:

Section 453, Internal Revenue Code:

1) In general

The term “installment sale” means a disposition of property where at least 1 payment is to be received

after the close of the taxable year in which the disposition occurs.

(2) Exceptions

The term “installment sale” does not include—

(A) Dealer dispositions

Any dealer disposition (as defined in subsection (l)).

(B) Inventories of personal property

A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

What Our Seller Achieves

- Investment of the *gross, pre-tax* proceeds with a financial services firm or other assets which our seller selects or approves, to produce an income stream that is paid directly to our seller
- Freedom from concern about the buyer’s performance or credit
- Freedom from management responsibilities for the business, asset or property that is sold
- An investment that is as diversified as our seller wants, instead of the risk that attaches to a concentrated investment
- Deferral of the capital gains tax until the installment contract calls for the principal to be paid, which can be for as much as 30 years
- Freedom of timing for the disposition, without the limitations, loss of bargaining power and implicit price premiums that go with tax-deferred exchanges
- Easier deal-making, because our seller and the ultimate buyer achieve their desired objectives, even when inconsistent with each other’s

- A high level of security for the invested sales proceeds, through the use of a “vault” company which holds ownership of the invested sales proceeds for our seller’s benefit
- Improved cash flow, as low-producing assets are replaced with an income stream from a portfolio
- Facilitated estate and retirement planning
- More freedom of action when our seller is only one of multiple owners of the asset to be sold
- Easy portfolio re-allocation
- Resources to service or reduce debt on other properties or assets
- Cash processing by an independent third party whom the seller selects or approves
- Easier resolution of price-allocation issues between our seller and the ultimate buyer
- When a business is to be sold, ability to accomplish much the same result as would be the case for an all-capital-gain sale of the capital stock, while the ultimate buyer is able to purchase assets
- Refinancing assistance on the sale of encumbered assets

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The Story of the Collateralized Installment Sale

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