FEDERAL INCOME TAX PROBLEMS IN WORKOUTS
(Workshop Materials)

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In this workshop, we will examine some of the more common federal income tax problems encountered in the context of real estate workout situations, including problems associated with debt relief, bankruptcy and loan restructuring transactions. The primary emphasis of the workshop will be on issue recognition. Our goals will be to provide the real estate practitioner with a better understanding of the federal income tax issues that arise in workout situations.

I. The Basics.

Federal income tax issues that can be associated with debt relief, bankruptcy and loan restructuring transactions are frequently very complex and frequently do not lend themselves to "Black Letter" treatment. However, there are certain basic principles of tax law that every real estate practitioner involved in workouts should know:

A. Discharge Results in Income.

Subject to certain narrow exceptions, the discharge (as opposed to actual payment) of indebtedness in whole or in part results in income to the extent of the discharge. IRC Sec. 61(a)(12).

B. Foreclosures Treated as Sales.

A foreclosure is considered a sale of the collateral for an amount equal to portion of the secured indebtedness that is satisfied as a result of the foreclosure (subject to fair market value limitations in the case of recourse debt). This sale, like any other sale or other disposition of the property, may give rise to gain or loss. Reg. Sec. 1.1001-2(a)(4).

C. Modifications May Result in Income.

A modification of an indebtedness to change the interest rate or terms can give rise to recognition of income even if the principal amount of the debt is not reduced. IRC Sec. 1274 and Reg. Sec. 1.1274-1(c).
D. **Holders of Installment Receivables.**

In general, a seller can foreclose a purchase money installment receivable without adverse tax consequences, but all other holders of installment receivables may recognize gain or loss on foreclosure. IRC Sec. 1038 and Sec. 453B.

II. **Bankruptcy Proceedings.**

Bankruptcy proceedings are essentially court supervised proceedings to effect voluntary or involuntary debt relief or modification. Proceeding in bankruptcy and planning for the filing of a bankruptcy proceeding should therefore *always* involve careful tax planning.

A. **Individual Bankruptcies.**

On the filing of a bankruptcy proceeding (under Chapter 7 or 13) by any *individual* debtor, there is created a new and distinct taxpayer -the bankruptcy estate. IRC Sec. 1398. The following matters are relevant to *individual* bankruptcy proceedings:

1. **Transfers to the Bankruptcy Estate.**

   The transfer of all the debtor’s assets to the bankruptcy estate that is deemed to occur on the filing of the petition is *not* a taxable event. IRC Sec. 1398 (f). But see *In Re Matter of Rasmussen*, 95 BR 657 (Bankr Y-113 Mo 1989).

2. **Carryover of Attributes.**

   The bankruptcy estate takes the transferred property with all existing tax attributes such as net operating loss carryovers, charitable contribution carryovers, exclusion of tax benefit recoveries, tax credit carryovers, basis, holding periods, character of assets, method of accounting, and other tax attributes of to the transferred property. IRC Sec. 1398(g).

3. **Discharge of Indebtedness Income Excluded.**

   A discharge of indebtedness that occurs in any Title 11 (bankruptcy) case or when the taxpayer is insolvent is an exception to the general rule and the amount of discharged indebtedness is *excluded* in computing the taxable income of the taxpayer (remember: the taxpayer is the bankruptcy estate and not the debtor in Chapter 7 and 11 cases). IRC Sec. 108(a)(1).
4. **Reduction of Attributes.**

When a taxpayer excludes discharge of indebtedness income under IRC Sec. 108(a)(1) due to insolvency or in a bankrupt case, the taxpayer is required to reduce certain tax attributes. The attributes that must be reduced are the following (listed in order of priority of reduction):

a. NOL carryovers;

b. investment, energy and similar tax credit carryovers;

c. Capital loss carryovers;

d. Basis of taxpayer's remaining assets (but not below fair market value); and

e. Foreign tax credit carryovers.

Any excess discharge of indebtedness income is simply ignored. The effect of this requirement is to convert the exclusion to a deferral to the extent the taxpayer could have used the listed attributes to reduce the tax liability that otherwise would have arisen in the absence of the provisions of IRC Sec. 108(a)(1). As an alternative approach, a taxpayer may elect to reduce the basis of depreciable property held by the taxpayer at the beginning of the first taxable year after the discharge. IRC Sec. 108(d)(5).

5. **Limitation on Exclusion.**

The exclusion for discharges arising in a bankruptcy case is available only if the discharge "is granted by the court" or results from a confirmed plan of arrangement. IRC Sec. 108(d)(2).

6. **Meaning of "Insolvent".**

Under Section 108(d)(3), "insolvent" means insolvent in the balance sheet sense - that is, that the taxpayer's liabilities exceed the assets. This is not the test employed under the Bankruptcy Code to permit the filing of a Chapter 11 proceeding. Compare 130 Cong. Rec. H 7482 (June 29, 1984) Legislative History to Bankruptcy Code Sec. 303: "[Sec. 303(h)] represents the most significant departure from present law... which requires balance sheet insolvency... The only basis for an involuntary case will be the inability of the debtor to meet its debts."
7. Importance of Timing.

Timing for filing a Chapter 7 or 11 case can be of critical importance to an individual debtor - a recognition event that takes place after the commencement of the case is taxable to the estate; one that takes place before the case is taxable to the debtor. See IRC Sec. 1398(d)(2) re: special short year election.

8. Farm Workouts.

Farmers are deemed to be insolvent and are eligible for the favorable debt discharge rules set forth in paragraphs 3 and 4 above with respect to "qualified farm indebtedness." IRC Sec. 108(g).


A real estate investor often owns heavily encumbered property with a very low tax basis. If an individual debtor files a Chapter 7 or 11 case, the property is transferred to the estate at the debtor's basis in a nonrecognition transaction. IRC Sect. 1398(f)(1). Subsequent disposition of the property will be taxable to the bankruptcy estate, not the post-petition debtor. If the property is so encumbered the estate receives insufficient proceeds from the sale, the taxes are either paid out of the other assets in the debtor's estate or are never paid. The debtor is free of the tax.

a. However, a well-informed Chapter 7 trustee or unsecured creditors committee may object to the tax liability and seek to abandon the property back to the debtor under Bankruptcy Code Section 554. If such an abandonment is successful (and the case authorities are still insufficient to be clear), the post-petition debtor may find the tax liability of foreclosure has reattached. A settlement with the trustee or unsecured creditors may be the best course.

b. A creative alternative to avoiding the tax and the abandonment problem is suggested in a recent article by D. Lauder and Hon. R. Martin, "Key Issues Regarding Liquidating Plans in Small and Medium Size Chapter 11 Cases," No. 11 Norton Bankruptcy Law Adviser, 8 (Nov 1989).

10. Other Tax Advantages of Bankruptcy.

In addition to the shifting of tax liabilities to a bankruptcy estate, individuals can obtain the following tax advantages from a bankruptcy case as compared to a nonbankruptcy liquidation:

a. Keep the tax collector from the door with the automatic stay: Bankruptcy Code Sec. 362(a).
b. Because unpaid taxes are paid as priority claims, bankruptcy can allow a debtor to prefer the IRS over other creditors. Bankruptcy Code Sec. 507(a)(7).

c. Favorable debt discharge income tax treatment is available for individual bankruptcy estates. IRC § 108(a)(1)(A). A solvent debtor who elects to file a bankruptcy case may avail itself of the debt discharge rules of a debtor in bankruptcy rather than the rules for a solvent taxpayer outside of bankruptcy. In such a case, the tax advantages of bankruptcy could be substantial. A solvent taxpayer may have significant debt discharge income if the solvent debtor has nonrecourse indebtedness. But see Bankruptcy Code Sec. 1111(b) (in certain circumstances, nonrecourse debt has general recourse against a Chapter 11 debtor).

d. The debtor has an opportunity to purchase assets from the bankruptcy estate. IRC § 1398(f).

e. A bankruptcy estate may deduct administrative expenses whether or not an individual could deduct such expenses. IRC § 1398(h).

f. The bankruptcy court may be a faster and more benevolent forum than tax court to determine income tax issues, e.g., BC§ 505(b). But see In re Hunt, 95 BR 442 (Bankr ND Tx 1989).

g. Bankruptcy may be a way to delay sale of property to allow tax credits to vest and delay recapture of depreciation and debt discharge income.

B. Partnership Bankruptcies.

The filing of a bankruptcy petition by a partnership does not create a separate taxpayer. IRC Sec. 1399. The deemed transfer to the partnership estate in bankruptcy, however, is not a taxable event and the partnership in bankruptcy continues to flow through all tax attributes to the partners as though no bankruptcy proceeding had occurred. IRC Sec. 108(d)(6). In short, the provisions of IRC Sec. 108(a) and (b) are applied at the partner level rather than partnership level. IRC Sec. 108(d)(6). Thus, in the case of a partnership:

1. No Exclusion.

Gain from discharge of partnership indebtedness will not be excluded from the gross income of solvent partners (under those partners are debtors in their own bankruptcy case).
2. **Flow Through Continues.**

Partnership losses will continue to flow through to the individual partners.

3. **Attributes Unchanged.**

Other tax attributes of partnership property (such as character as capital assets, holding periods, basis in partnership interest, etc.) are not changed as to the individual partners.

C. **S Corporations.**

The rules for S corporations are substantially the same as for partnerships.

D. **Property Taxes.**

In a dramatic development, two Circuits have now held that secured creditors may set aside property tax liens for years beginning after the filing of the debtor's bankruptcy case, with the result that secured creditors may avoid responsibility for property taxes that accrue during a bankruptcy case. Such property taxes either become an administrative expense or seventh priority claim. See *In re Parr Meadows Racing Assn, Inc.*, 880 F2d 1540 (2d Cir 1989); and *Equibank, NA v. Wheeling-Pittsburgh Steel Corp.*, 884 172d 80 (3rd Cir 1989).

E. **Interest on Secured Tax Claims.**


III. **Discharge of Indebtedness Income.**

Discharge of indebtedness generally occurs whenever a debtor obtains the benefit of debt relief through any means other than payment of the debt by the debtor at par. Under existing tax law, the gross income of all taxpayers must include an amount equal to any and all discharged debt.

A. **Indebtedness Subject to Discharge.**

Indebtedness that is subject to "discharge" includes any debt on which the taxpayer is liable or "subject to which the taxpayer holds property." IRC Sec. 108(d).
Thus, non-recourse mortgage debt is subject to discharge and recognition of income to the extent of the discharge.

B. Examples of Discharge.

A discharge of indebtedness can occur in a number of ways and under a wide variety of circumstances. Consider, for example, the following:

1. Write-Down.

Debt is written down in a chapter 11 proceeding or as part of a loan workout agreement.

2. Modification.

Partnership debt is modified in a way that gives rise to a discharge. (See Section V of these materials.)

3. Interest Adjustment.

Accrued interest is written off, compromised or otherwise adjusted downward. Note, however, that cancellation of accrued interest will not necessarily give rise to forgiveness of indebtedness income unless the accrued interest had been deducted by the taxpayer in a prior year. Thus, a cash basis taxpayer may be able to write off interest without recognition of income. Also, IRC Sec. 108(e)(2) provides that recognition of income will not be required from discharge of an obligation if payment of the obligation would have given rise to a deduction.

4. Assumption.

*Recourse* debt in excess of the fair market value of the property securing the repayment of the debt is assumed by the transferee (the excess over fair market value is treated as discharged indebtedness). An amount equal to the fair market value is treated as proceeds of a disposition. See Section IV of these materials.

C. Purchase Money Debt.

A write-down of purchase money debt is treated as a reduction in purchase price rather than as a discharge of indebtedness, but only if the debtor is solvent at the time of the reduction and the reduction does not arise out of a bankruptcy case. See IRC Sec. 108(e)(5).
D. Partnership Basis.

In the case of partnerships, income from the discharge of indebtedness gives rise to fairly straightforward basis adjustment rules under IRC Sec. 705:

1. Increase.

Each partner's basis is increased by the partner's share of discharge of indebtedness income.

2. Decrease.

Each partner's basis is decreased by the amount of the deemed distribution of cash resulting from the partner's reduction in share of partnership liabilities. IRC Secs. 705, 733, and 752.

E. Disproportionate Allocations.

The increases and decreases required under IRC Sec. 705 must offset each other exactly if all of the partners expect to avoid more than their share of discharge of indebtedness income. However, many partnerships allocate income in one ratio and losses in another. Moreover, under the old regulations under IRC Sec. 752, recourse debt was required to be allocated in accordance with loss ratios. Thus, care should be taken to insure that some partners do not get unanticipated and unwanted "phantom" income that could have been avoided through different allocations under the partnership agreement.

F. Special Allocation.

In order to ensure this result, the partnership agreement should provide or be amended to provide for a special allocation of forgiveness income to the partner or partners that included the indebtedness in their basis.

IV. Foreclosures and Transactions in Lieu of Foreclosure.

Foreclosures and deed in lieu of foreclosure transactions are considered sales or exchanges of the security property. As a result, foreclosures and transactions in lieu of foreclosure will almost always have substantial tax effects.

A. Foreclosures Treated as Disposition.

A disposition of property, whether by sale, exchange, foreclosure, or deed in lieu of foreclosure, gives rise to a gain or loss, depending on the proceeds realized on the disposition and the taxpayer's basis in the property. Thus:
1. **Recourse Loans.**

A foreclosure of a *recourse* mortgage loan will give rise to the recognition of gain on the sale (to the extent the debt exceeds basis), rather than recognition of discharge of indebtedness income, but only to the extent of the fair market value of the security. See IRC Reg. 1.1001-2(c), *example* (8). The excess of the recourse obligation over fair market value will be treated as discharge of indebtedness income. Note: many court cases addressing the issue have not followed this approach. *See, e.g.*, *Peninsula Properties Co. v. Commissioner*, 47 B.T.A. 84 (1942).

2. **Non-Recourse Loans.**

A foreclosure of *non-recourse* debt will not give rise to discharge of indebtedness income. Under current interpretation of tax law, the entire amount of a non-recourse debt in excess of basis is treated as gain on the disposition, regardless of the fair market value of the security that was foreclosed. See IRC Reg. 1.1001-2(c), *example* (7). *See also Commissioner v. Tufts*, 461 U.S. 300 (1983). This can be very disadvantageous. Consider instead using a workout agreement which provides for a partial write-down (generating debt-discharge income) followed by the foreclosure.

B. **Bifurcation Approach.**

This "bifurcation" of the income realized on foreclosure of recourse debt may provide an insolvent or debtor in a bankruptcy proceeding with the opportunity to recognize income under IRC Sec. 108. [This approach gets a lot of attention from tax practitioners, but probably has little practical significance as long as the tax rates on capital gains and ordinary income are the same.]

V. **Loan Modifications.**

Loan modifications involving a principal reduction or write-off will always result in discharge of indebtedness income. Practitioners are frequently surprised, however, to learn other modifications, especially those involving interest rate changes, can result in the recognition of income.

A. **Modifications Generally.**

As indicated above, the write-down of principal and under certain circumstances the cancellation of accrued but unpaid interest will obviously give rise to discharge of indebtedness income. Modifications not involving principal reductions, however, may also give rise to forgiveness of indebtedness income,
especially if the modification involves a reduction in the interest rate. See Section IIIC for the rule on modification of purchase money indebtedness still held by the seller.

B. Modification of Interest Rate.

The modification of interest rate on post 1984 debt instruments can give rise to recognition of income either under IRC Sec. 1274 (original issue discount) or under IRC Sec. 483 (imputed interest).

C. Extension of OID Rules.

The Deficit Reduction Act of 1984 extended the application of the OID rules to nontraded property. As a result, under the provisions of IRC Reg. 1.1274-1(c), a material modification of a debt instrument subject to IRC 1274 is treated as an exchange of the old debt instrument for the modified debt instrument.

D. Operation of Rules.

To the extent the original issue price of the debt (i.e. the amount advanced and outstanding under the debt instrument, assuming no OID in connection with the original transaction) is not equal to the fair market value (or imputed principal amount) of the debt as modified (determined by discounting the remaining principal balance of the debt over the term at the Applicable Federal Rate, which is the rate prescribed from time to time by the IRS), then:

1. Gain or Loss.

The creditor will recognize gain or loss to the extent of the difference.

2. Discharge of Indebtedness Income.

Subject to the provisions of Section 108, the debtor will recognize discharge of indebtedness income to the extent the issue price of the original instrument exceeds the fair market value of the modified debt instrument. The debtor will also get OID expense deductions over the remaining life of the loan. The total amount of deductions will equal the amount of discharge of indebtedness income.

E. Materiality.

As noted, the debt modification rules under IRC Sec. 1274 apply to modifications that are material. The exact language of the regulations is "'materially either in kind or in extent,' within the meaning of ... 1.1001-1(a)." Consider the following types of modifications:
1. Change in Principal or Interest.

A change in the interest rate (the examples under IRC Sec. 1274 involve changes of a 6 percentage point reduction, a 1 percentage point increase, and a 3 percentage point increase with an accrual feature). See also Rev. Rul. 81-169, 1981-1 C.B. 429 (involving a one-half percentage point decrease). Under Rev. Rul. 89-122, the service declared that any change in interest rate or reduction in principal would be a "material modification."

2. Change in Maturity Dates.

A change in maturity dates has been held to be material in some cases and not material in others. However, in view of the focus of IRC Sec. 1274 and the proposed regulations on the time value of money determined through discounting at a specified rate over a specified time period, a change in maturity dates would probably be considered material, especially if the change affected the fair market value of the instrument. In essence, the answer will probably beg the question.


A change in security should not be considered a "material" modification unless the substituted security is worth less than the debt and less than the old security.

F. Non-Recourse Debt.

Non-recourse debt presents especially troublesome problems. The code and the proposed regulations identify as "potentially abusive" any non-recourse financing and any financing involving a tax shelter. In potentially abusive situations, the maximum amount of the issue price (i.e., fair market value) of the modified debt instrument is the fair market value of the property; yet the issue price of the original debt instrument is the amount originally advanced, without regard to fair market value. See IRC Sec. 1274(b)(3) and Prop. Reg. 1.1274(b)(3)(B)(ii)(II).

G. Pre-1985 Debt.

Old IRC Sec. 483 should still govern pre-1985 seller financed debt instruments arising from a sale or exchange that took place prior to 1985, even if modified after 1984. IRC Prop. Reg. 1.483-1(e) and 1.1274-1(e)(1). Old Sec. 483 was applicable to seller provided purchase money financing taken back as part of the purchase price. Very complicated rules generally provided for testing the instrument to determine if the modified interest rate was adequate. If not, then some portion of future principal payments would be converted to interest and the property owner would be required to
reduce basis in the property to that extent. The modification would not give rise to discharge of indebtedness income.

H. Installment Obligations.

Modification of installment obligations can have substantial adverse consequences. Under IRC Sec. 453B, the disposition of an installment receivable results in gain or loss to the holder of the receivable. Fortunately, the standard of determining whether an disposition has occurred under IRC Sec. 453B is not as encompassing as the standard under IRC Sec. 1001. The Sec. 453B standard was expressed in Rev. Rul. 75-457, 1975-2 C.B. 196 as follows: ",...[a 453B disposition] occurs when ... [the seller's rights] either disappear or are materially disposed of or altered so that the need for postponing recognition of gain ... ceased."

I. Transfers and Assumptions.

Modifications in connections with transfers and assumptions are governed by special rules. In general, the tax results to the creditor are the same as for other modifications. For the debtor, however, the results may be different.


In general, IRC Reg. 1.1274-7(a)(2) provides that all modifications will be deemed to occur before the transfer, unless the seller neither consents to the modification nor participates in any way.

2. Tax Effects.

Thus, the seller may experience a recognition of income to the extent of the discharge amount, but this amount would be offset to some extent by the diminution of the amount that would be treated as gain on the sale and transfer. The purchaser/assumptor takes subject to the modified debt and the purchaser's basis will be the issue price, determined in accordance with the principles of IRC Sec. 1274.

3. Post-Transfer Modifications.

If the modification is deemed to have taken place after the sale or exchange, there are generally no tax consequences to the debtor/seller resulting from the exchange and the tax results become the problem of the transferee.

VI. Foreclosure-Effect on Holders of Installment Receivables.

Foreclosures not only affect the debtor, but in the case of holders of installment receivables, the foreclosure can have substantial tax consequences to the note holder.
A. Seller-Held Mortgages.

In the case of purchase money financing *that continues to be held by the seller/mortgagee*, the foreclosing seller will generally escape any adverse tax consequences. IRC Sec. 1038. However, gain must be recognized to the extent actual cash received prior to the foreclosure sale exceed the amount of such payments that had been taken into income by the foreclosing seller. IRC Sec. 1038(b)(1).

B. Other Installment Receivables.

In all other cases involving the foreclosure of an installment receivable, the holder is required to recognize gain or loss to the extent of the difference between the foreclosing seller's basis in the obligation and the amount realized on the foreclosure. IRC Sec. 45313.

1. Seller's Basis in Obligation.

The foreclosing seller's basis in the obligation is equal to that portion of the receivable that foreclosing seller still has not taken into income as a result of Sec. 453B (installment sales).

2. Amount Realized.

The amount realized should be the fair market value of the property reacquired. IRC Sec. 45313.