

The Purchase Requirement in Section 1042 Transactions: Using Seller Notes to Purchase Qualified Replacement Property (Part 3)

By Heather Fincher and Ian Weinstock

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Seller notes are a practical necessity in many employee stock ownership plan ("ESOP") transactions because they facilitate a sale of company stock by a shareholder (generally referred to below as a "seller") to the ESOP when the ESOP lacks sufficient cash to pay the full purchase price upfront. But that practical solution can create serious technical problems for sellers who seek Internal Revenue Code ("IRC") section 1042 deferral by purchasing qualified replacement property ("QRP").[1]

As Part 2 of this three-part series of articles explained, purchasing QRP using cash or its equivalent satisfies section 1042's purchase requirement pursuant to the definition provided in temporary regulations. A typical subordinated ESOP seller note, however, generally is not "cash or its equivalent." Such a note often lacks the unconditional, assignable, and readily marketable character of promises to pay treated as cash equivalents because it is often subordinated to senior debt, may delay principal amortization, has an extended maturity, restricts transfer, permits potential offsets, lacks collateral, and has no ready secondary market in which it can be sold at or near face value.

This Part 3 picks up where the Part 2 analysis left off by addressing the question of whether the seller note may nevertheless be used as property exchanged for QRP. This question typically arises in the context of a seller wishing to exchange an ESOP seller note for stock in a closely-held corporation. Although it is technically possible for a seller to exchange a seller note for QRP if structured carefully, sellers should approach that sort of transaction with caution. These transactions involve multiple unresolved tax issues and risks, and critically, a note with a fair market value below its face amount can trigger significant income tax consequences even if the transaction otherwise satisfies the purchase requirement under section 1042.

Tax Realization and Non-Recognition for Seller Notes

A brief overview of the basic rules on tax realization and the statutory requirements for deferring gain recognition will help to explain our analysis of whether a seller note may be used to acquire QRP when the note is not treated as cash or a cash equivalent.

Under section 1001, a taxpayer realizes gain on a sale or disposition of appreciated property to the extent the "amount realized" (generally, the sum of any money received plus the fair market value of property received) exceeds the taxpayer's adjusted basis in the property.[2] Although fair market value is generally a question of fact[3], when a *bona fide*[4] debt instrument is issued in exchange for property, special rules provide that the amount realized is the debt instrument's "issue price."[5] Where the instrument (i) is neither publicly traded nor issued for publicly traded property and (ii) bears adequate stated interest, the issue price is generally the stated principal amount, regardless of the instrument's actual fair market value.[6] Therefore, a seller who receives a seller note in exchange for stock sold to an ESOP realizes gain at the time of the sale to the extent the note's stated principal amount (*i.e.*, its face amount) exceeds the seller's basis in the stock sold.

However, such gain realized at the time of sale may not have to be *recognized* in the year of sale. Sections 453 and 1042 are two provisions that govern when gain realized upon receipt of a seller note must be recognized. For a qualifying installment sale, section 453 automatically defers recognition of the realized gain until the taxpayer receives principal payments on the seller note, unless the taxpayer elects out under section 453(d) and takes into account the entire gain in the year of sale.[7] Under section 1042, as explained in Part 1, realized gain from the ESOP sale is not recognized to the extent the taxpayer timely purchases QRP with sufficient cost to shelter the amount realized and all requirements are met. The potential interplay between sections 453 and 1042 is addressed below.

The Cost-Basis Test for "Purchase" of QRP

A threshold question here is what constitutes a "purchase" of QRP under section 1042. A seller is treated as "purchasing" QRP only when basis in the QRP is determined by reference to its *acquisition cost*, which is defined in temporary regulations as follows:

> For purposes of section 1042(a), there is a "purchase" of qualified replacement property only if the basis of such property is determined by reference to its cost to the taxpayer. If the basis of the qualified replacement property is determined by reference to its basis in the hands of the transferor thereof or another person, or by reference to the basis of property (other than cash or its equivalent) exchanged for such property, then the basis of such property is not determined solely by reference to its cost to the taxpayer.[8]

The temporary regulations, therefore, clearly provide: (1) cash or its equivalent may be used to purchase QRP, and (2) transactions that produce a substituted or carryover basis fail the test. It is the area between what definitely works and what definitely does not work—namely, non-cash-equivalent property exchanged for QRP in a transaction that would otherwise generate gain or loss—that constitutes the primary focus of this article.

No precedential authority confirms that non-cash-equivalent property may be exchanged for QRP under section 1042, leaving the approach untested. In fact, the only authority directly addressing the use of ESOP seller notes to acquire QRP stock at all is Private Letter Ruling 9321067. As detailed in Part 2 of this series, the Internal Revenue Service ("IRS") concluded that the acquisition of the new corporation's stock constituted a purchase for purposes of section 1042 provided that the ESOP seller note constituted a cash equivalent. In other words, the ruling *assumed* that the seller note was a cash equivalent rather than *determining* that it was. Further, the ruling did not address whether noncash property could instead be exchanged for QRP and satisfy the purchase requirement, though the ruling's silence on that point should not be surprising: because the transaction seemed to be a qualifying 351 transaction, the only path to satisfying the section 1042 purchase requirement would be by using cash or its equivalent.

Lack of precedential authority aside, however, the regulations implicitly contemplate that a taxpayer can exchange property that is not cash or its equivalent to purchase QRP under section 1042 because they specifically refer to "property (other than cash or its equivalent)." Were that not the case, the regulations would presumably refer only to "cash or its equivalent."

Section 351 and the Cost-Basis Problem

The classic example of a substituted or carryover basis transaction is a section 351 exchange, where one or more persons (each a "transferor") transfer appreciated property to a corporation solely in exchange for stock and, immediately afterward, control the corporation. The stock a transferor receives from the corporation in a valid section 351 exchange takes a substituted basis under section 358 equal to the transferor's basis in the property contributed to the corporation, and no gain is recognized by either the corporation or the transferor.[9] Because the transferor's basis in the newly acquired stock is determined by reference to the transferor's basis in the property exchanged for that stock, rather than the acquisition cost of the stock, this is not a valid "purchase" under section 1042.

Sellers often seek to acquire stock in a newly formed corporation ("Newco") as QRP because of the flexibility a Newco offers to satisfy section 1042's requirements. Acquiring Newco stock with cash or its equivalent qualifies as a purchase under the regulatory definition, assuming all other section 1042 requirements are satisfied. In contrast, a contribution of a seller note in a section 351 exchange clearly fails to satisfy the purchase requirement. Therefore, if a seller contributes

ESOP seller notes to a Newco in a transaction that is section 351 qualifying, the seller *has not purchased* QRP under section 1042.

Because section 351 treatment is not elective (*i.e.,* if a taxpayer contributes seller notes to Newco in a transaction that satisfies section 351's requirements, then section 351 applies automatically and section 1042's purchase requirement is not satisfied), selling shareholders seeking to transfer seller notes to a Newco in exchange for QRP need to structure the transaction deliberately to fall outside of section 351's nonrecognition treatment, *i.e.,* a so-called "busted" section 351 exchange. A busted section 351 exchange is taxable, giving the seller an acquisition-cost basis in the Newco stock. Although it may sound simple in concept, a busted section 351 exchange requires careful planning. For example, sellers may seek to avoid section 351 by deliberately failing section 351's control requirement by ensuring transferors do not control 80 percent or more of Newco immediately after transferring property.[10] Moreover, sellers should ensure the designed transaction has independent economic substance, rather than a formal or circular arrangement designed solely to avoid section 351, so that step-transaction or substance-over-form principles cannot otherwise recharacterize the exchange.[11]

Assuming section 351 can be avoided, the analysis shifts to the issue of whether the seller note can be exchanged for QRP so that the seller's basis in the stock acquired as QRP is its acquisition cost.

Can Noncash Property Be Used to Purchase QRP?

Although there is no 1042 tax authority directly on point, there is authority supporting the position that a seller can obtain cost basis in a noncash or non-cash-equivalent property-for-QRP exchange, and thus potentially meet the purchase requirement. Federal tax law generally treats an exchange of one property for another as a taxable event under section 1001, analyzed in two integrated steps:[12] the disposition of the property transferred is a realization event under section 1001; and the property received takes an acquisition cost basis under section 1012.[13]

Courts have treated bona fide debt as "property" for section 1001 purposes, supporting the position that a properly structured ESOP seller note may be exchanged for QRP.[14] In a leveraged ESOP transaction, a foundational assumption is that the seller note constitutes *bona fide* debt respected as property (and thus an asset capable of being exchanged for QRP) which is typically not a major concern because properly structured ESOP seller financing contains multiple safeguards supporting such treatment.[15]

Accordingly, if a seller note-for-QRP stock exchange is taxable because no nonrecognition provision, such as section 351, applies, the QRP stock should take a new cost basis under section 1012 rather than a substituted basis determined by reference to the seller's basis in the note. This result arguably satisfies the section 1042 purchase requirement because the temporary

regulations prohibit only transactions producing a substituted or carryover basis. There are, however, additional tax consequences that taxpayers should carefully consider.

Gain-Recognition in Exchanged Seller Notes

In a seller's sale of company stock to the ESOP for a note, installment sale treatment automatically applies under section 453 when at least one payment is to be received after the year of sale, assuming the seller does not affirmatively elect out of the installment sale rules.[16] Without section 1042, a seller's gain would be recognized over the life of the installment note as principal payments are received under section 453(a). But with section 1042, gain that otherwise would be recognized is further deferred unless a gain recapture event occurs, such as the seller's disposition of QRP under section 1042(e).[17] However, using the seller note to acquire QRP can itself result in gain-recognition events separate from the original sale.

Interplay of Sections 453, 453B and 1042

Section 453B accelerates gain deferred on an installment sale when the installment obligation is sold, distributed, or otherwise disposed of.[18] The exchange of a seller note for Newco stock is such a disposition, causing the seller to recognize remaining gain previously deferred under section 453.[19] The question then becomes whether section 1042 defers the gain otherwise accelerated by section 453B on disposition of the note.

Section 1042 protects the original ESOP stock sale by deferring long-term capital gain that would otherwise be recognized at that time,[20] and that protection is not necessarily limited to gain recognized in the year of the ESOP sale. The Tax Court in *Berman v. Commissioner* recently held that section 1042 also defers gain on subsequent installment payments received under a seller note.[21] Unlike the installment payments in *Berman*, however, exchanging a seller note for QRP is a section 453B disposition, and it is unclear whether *Berman's* reasoning extends to that gain.

Section 453B terminates installment-method deferral and requires recognition of the excess of the amount realized or fair market value over the obligation's basis, which essentially is unrecovered gross profit on the stock sale. Although the statute treats this gain as resulting from the sale or exchange of the underlying property, courts have interpreted that language as determining the gain's character and holding period, not as reopening the original installment sale.[22]A taxpayer may argue that, just as *Berman* harmonized sections 453 and 1042 by applying section 1042 only to the gain that "would be recognized" under the installment method, section 1042 likewise defers the gain that section 453B would otherwise require a seller to recognize upon disposition of the seller note. However, the contrary argument is that the gain arises from a distinct disposition of the note occurring after the section 1042 sale, *i.e.,* that section 453B's acceleration provisions take precedence over section 1042's deferral provisions. Given this uncertainty, a taxpayer seeking to acquire QRP with a seller note may consider electing out of

section 453 to take section 453B off the table entirely (though only after taking into consideration the other possible implications noted below).

Valuation Risk in Using Seller Notes to Purchase QRP

As described above, when the ESOP issues the seller note, the seller's amount realized is determined with reference to the note's stated *principal amount* (assuming the note provides adequate stated interest).[23] And when a seller exchanges a seller note for QRP in a Newco, the QRP's acquisition cost is generally based on the *fair market value* of the seller note. Consequently, to the extent the fair market value is less than its stated principal amount, an exchange of the seller note for QRP can inadvertently trigger gain that the seller intended to be deferred under section 1042 because the value of the QRP acquired may be less than the amount realized from the ESOP sale.[24]

Where a difficult-to-value asset is exchanged for a readily-valued asset in an arm's length transaction, the value of the difficult-to-value asset can be presumed to be equal to that of the readily-valued asset.[25] But where a seller note is exchanged for stock in a Newco, the value of the stock is not readily valued. In fact, the value of the company is presumably determined largely if not entirely by the seller note itself.

But why do we care? As long as the exchange of the seller note for the stock in the newly formed company is a property-for-property exchange not covered by section 351, the result of the exchange is that the seller's basis in the QRP is its acquisition cost. It might therefore seem that, even if the seller doesn't know what that acquisition cost is, the transaction will satisfy section 1042's requirements. However, if the note is worth less than its face amount, the seller may not have acquired enough QRP to match the amount realized on the ESOP sale; unless the seller acquires additional QRP to cover that shortfall, the unmatched portion of the ESOP sale proceeds could be recognized as gain. Moreover, as discussed below, depending on the transaction structure and interpretation of open tax issues, additional tax implications may result.

For income tax purposes, the fair market value of a promissory note issued by a closely held company is not necessarily its face amount. Instead, its fair market value is a question of fact determined from all of the relevant evidence and measured by what a willing buyer would pay a willing seller when neither is under any compulsion to buy or sell and both are reasonably informed as to all relevant facts.[26]

Estate tax valuation authorities may inform the valuation analysis of a note and generally focus on the note's contractual cash flows and any risks associated with receiving those payments.[27] Relevant factors may include the financial condition and creditworthiness of the obligor; the stated interest rate compared with the yield required on comparable obligations; the term to maturity and timing of principal payments; the note's priority in the capital structure, including

subordination to other indebtedness; whether the obligation is secured and the adequacy of any collateral; restrictions on transfer and the availability of a market for the instrument; and other contractual provisions affecting the likelihood, timing, or enforceability of payment.

These considerations are particularly relevant to ESOP seller notes. Such notes are frequently subordinated to senior lenders, unsecured, subject to delayed principal amortization, have transfer restrictions, are subject to setoff, and / or are dependent upon the future performance of a leveraged privately held company for repayment. Each of these characteristics may affect the return demanded by an unrelated party and therefore the price a willing buyer would pay for the note.[28]

Income tax cases illustrate the discount in reaching a note's fair market value can be meaningful. In *Hegra Note Corp.*, the Fifth Circuit upheld a determination that installment notes exchanged for corporate stock had a fair market value equal to approximately 66% of their face amount (*i.e.,* a 34% discount).[29] Similarly, in *Warren Jones*, the Ninth Circuit addressed a deferred payment obligation having a face amount of $133,000 but an agreed fair market value of $76,980, a discount of approximately 42% from face.[30] Other courts have sustained comparable discounts derived from a market yield analysis.[31]

This valuation exposure represents an additional vulnerability not ordinarily present in a conventional cash-based QRP purchase. Rather than challenging whether the acquired securities technically qualify as QRP, the IRS needs only to establish that the fair market value of the seller notes was less than their face amount, which is a potentially compelling position given the characteristics of typical ESOP seller notes.

Tax Consequences of the Seller Note Valuation Discount

The taxes triggered from the valuation discount depend on multiple issues, and some of these issues have not been addressed directly by existing authority. In all scenarios, however, there is one common result: some level of tax is triggered. The question is whether it is capital gain, ordinary income, or both, as well as when and to what extent it is recognized. Each of these issues is addressed in turn below and it involves a complicated series of analyses, depending on whether or not the taxpayer elects out of 453. For illustration purposes only, the following discussion uses the hypothetical where the seller note has a principal amount of $10 million and fair market value of $6.5 million.

Electing out of Section 453

Where the seller elects out of the installment method under section 453(d), the entire $10 million realized gain from the ESOP sale is taken into account in the year of sale. Because only $6.5 million of QRP is purchased, section 1042 shelters that amount and the taxpayer must recognize

gain on the $3.5 million shortfall. But the analysis does not stop there. Having taken the full $10 million into account, the taxpayer now holds a seller note with a $10 million tax basis. Its disposition for $6.5 million of Newco stock therefore produces a $3.5 million loss. Whether the taxpayer can use that loss to offset the $3.5 million gain depends upon two further issues: whether the loss is allowed under section 267 and whether it arises in the same taxable year as the sale. Yet even if the loss can be used, there can be additional income tax consequences.

a. Section 267 — Related Party Issue

Section 267(a)(1) disallows a loss on the sale or exchange of property between related persons, and section 267(b)(2) treats an individual and a corporation as related where the individual owns, directly or indirectly, more than 50% in value of the corporation's outstanding stock. Thus, where the taxpayer owns more than 50% of Newco, a deduction for the $3.5 million loss is disallowed and it cannot offset the section 1042 shortfall.[32]

b. Differing Tax Years

Even where a deduction for the loss is allowed, the loss offsets the $3.5 million gain only if it arises in the taxable year of the ESOP sale. Gain attributable to the section 1042 shortfall is taken into account in the year of the ESOP sale, whereas the loss on the seller note arises in the year of its taxable disposition. Because the period for purchase of QRP runs for 12 months following the ESOP sale, the two events may fall in different taxable years. Moreover, individuals may not carry a capital loss back to a prior year; under section 1212(b), the loss is instead carried forward and may only be used against future capital gains and a limited amount of ordinary income. Accordingly, the taxpayer can use the loss to offset the gain from the ESOP sale only if the seller note is exchanged in the same taxable year, which may present practical challenges depending on the timing of the sale.

c. Ordinary Income Through Newco

Newco also faces ordinary income tax consequences under the market discount rules under section 1276(a)(1). The market discount rules apply to a promissory note where the stated redemption price at maturity—here, $10 million—exceeds the holder's basis immediately after acquisition—here, $6.5 million. Section 1276(a) generally treats gain on a disposition and any partial principal payments as ordinary income to the extent of this difference.[33] The $3.5 million valuation discount thus results in ordinary income when the ESOP pays the $10 million it owes on the note.(And, if Newco is an S corporation, that ordinary income flows through to the seller.)

The valuation discount may therefore have consequences for both parties to the transaction, affecting the seller directly and Newco separately. For the seller, the $3.5 million discount may result in capital gain if the corresponding loss is disallowed because the seller controls Newco or because the QRP is purchased in a later taxable year. Separately, Newco generally recognizes the $3.5 million of market discount as ordinary income under section 1276 when the note is paid

off.[34] Moreover, even where the market discount rules do not apply, retirement of the note would be treated as an exchange under section 1271(a), presumably producing $3.5 million of capital gain.

No Election out of Section 453

Where the seller does not elect out of the installment method, the seller note remains an installment obligation. Its basis for purposes of section 453B generally equals its face amount reduced by the income that would be recognized if the obligation were satisfied in full. Thus, where the seller had a nominal basis in the stock sold to the ESOP, the note has little or no basis. In the continuing example, exchanging the seller note for $6.5 million of Newco stock therefore produces $6.5 million of gain under section 453B. Because section 453B measures gain by reference to the amount realized on disposition of the note, rather than the total gain deferred on the original stock sale, the remaining $3.5 million of realized gain is not recognized under section 453B. No loss arises on the exchange, so section 267(a)(1) does not apply. Under our view, section 1042 does not defer the $6.5 million of gain accelerated by section 453B. Under the taxpayer-favorable view, section 1042 applies to that gain, but the seller must still recognize $3.5 million because the $6.5 million cost of the QRP is insufficient to shelter the entire $10 million amount realized on the ESOP sale. Under either view, Newco acquires the note at a $3.5 million market discount and generally recognizes ordinary income attributable to that discount as principal payments are received or upon a disposition of the note, subject to the market discount accrual rules.

Conclusion

For sellers seeking section 1042 deferral, purchasing QRP with cash or its equivalent remains the most certain approach. It avoids the unresolved purchase, valuation, and gain-recognition issues that arise when a seller note is exchanged for QRP.

If a seller instead exchanges seller notes for purported QRP, the strategy presents substantial tax and valuation risks. First, if any non-cash-equivalent asset, including a seller note, is used to purchase QRP, the transaction must be structured to avoid section 351. Second, even if the exchange is structured to avoid section 351, the seller is treated as purchasing QRP only to the extent of the fair market value of the seller notes. Given the characteristics of typical ESOP seller notes discussed above, this presents a meaningful tax vulnerability for sellers using this structure. Finally, depending on whether the seller elects out of the installment method, the exchange may also produce gain under section 453B or a loss subject to section 267, while Newco may separately recognize ordinary income under the market discount rules. Because the interaction of these provisions remains unresolved, the amount, timing, and character of the resulting tax consequences may vary significantly with the transaction's structure and the note's

defensible fair market value. Accordingly, a seller considering this approach should be aware of the risks and consult with experienced tax counsel before committing to the transaction.



Heather Fincher, an Associate at Kostelanetz LLP, advises multinational businesses and high-net-worth individuals on U.S. federal income tax matters, with a particular focus on international tax planning and controversies. Heather previously worked as a tax attorney in the Washington, DC office of an Am Law 100 firm, served a Fortune 50 company through her own law firm, and launched an international tax education business. Heather received her JD, with high honors, from GW Law, and earned an LLM in Taxation from Georgetown Law, together with a Certificate in International Taxation.

Heather can be reached at hfincher@kostelanetz.com or 202-790-6996.



During the course of his more than 30-year legal career, Ian Weinstock has built a practice that spans the range of trusts, estates, and personal tax planning issues, including sophisticated estate planning techniques for ultra-high net worth individuals; choice-of-entity issues and succession planning for small businesses; philanthropic planning; the administration of decedents' estates; and advising fiduciaries and beneficiaries on all aspects of trust administration. With extensive in-house experience at major U.S. financial institutions, he advises corporate fiduciaries on all aspects of their businesses.

Ian can be reached at iweinstock@kostelanetz.com or 212-808-8100.

Endnotes

[1] Unless otherwise indicated, references to a section ("section" or "§") are to Title 26 U.S.C., the IRC of 1986, as amended, or Treasury regulations promulgated thereunder (the Code of Federal Regulations, Title 26, "Treas. Reg.").
[2 I.R.C. §1001(a)-(b).
[3] Treas. Reg. §1.1001-1(a) (providing fair market value is a question of fact, and property lacks an ascertainable fair market value only in rare and extraordinary cases).
[4] In a leveraged ESOP transaction, ESOP seller notes contain multiple safeguards that support *bona fide* debt treatment that are beyond the scope of this article.
[5] Treas. Reg. § 1.1001-1(g)(1).
[6] Treas. Reg. §§ 1.1001-1(g)(1); 1.1273-2(d)(1); 1.1274-2(b)(1).
[7] I.R.C. § 453(a), (c), (d). Section 453B may accelerate recognition upon disposition of the installment obligation. This issue is addressed later.
[8] Treas. Reg. § 1.1042-1T, Q&A-1(e).
[9] A tax-deferred Section 1031 exchange illustrates the same point, although Congress limited such exchanges to real property in 2017. The taxpayer's basis in the new property is derived from the taxpayer's basis in the exchanged property, so the new property is acquired with a substituted basis rather than an acquisition cost basis.
[10] "Control" in this context is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock. I.R.C. § 351(a) (cross-referencing section 368(c)).
[11] As discussed below, the 80% threshold also interacts with the related party rules of section 267 in a manner that narrows the structuring options available to the taxpayer. There are additional techniques to structure a "busted" 351 transaction that are beyond the scope of this article.
[12] In a taxable exchange, gain (or loss) realized from the sale or disposition of property is the difference between the amount realized and the taxpayer's adjusted basis in the property. I.R.C. § 1001(a). "Amount realized" is generally defined as the sum of any money received plus the fair market value of property received. I.R.C. § 1001(b). "Adjusted basis" is generally the cost of the property under section 1012 as adjusted under section 1016 (e.g., for exhaustion, wear, and tear allowed as deductions).
[13] *See* Treas. Reg. § 1.1012-1(a) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property . . .").
[14] *See, e.g., G.M. Trading Corp. v. Comm'r*, 103 T.C. 59, 67 (1994) ("Since debt constitutes property in the hands of the holder, an exchange of debt for other property is generally treated as a taxable exchange under section 1001" (citing cases)).
[15] *See* supra note 4.
[16] *See* I.R.C. § 453(a)-(d).
[17] *See Berman v. Comm'r*, 163 T.C. 1, 30-31 (2024).
[18] *See generally* I.R.C. § 453B(a); *Hegra Note Corp. v. Comm'r*, T.C. Memo. 1966-87, *aff'd* 387 F.2d 515 (5th Cir. 1967) (finding petitioner's transfer of third-party notes for stock constituted a disposition of the installment obligations within the meaning of predecessor to section 453B).
[19]A similar question may arise in a scenario where the company assumes a seller note issued by the ESOP and either modifies or replaces the note with a new company-issued note. Although this transaction could trigger a section 1001 exchange under the debt-modification rules, Treasury has indicated in the preamble to its final debt-modification regulations (T.D. 8675) that a modification resulting in a taxable exchange under section 1001 does not determine if there has been a disposition of an installment obligation under section 453B.
[20] I.R.C. § 1042(a).
[21] *See Berman v. Comm'r*, 163 T.C. 1, 28-30 (reconciling sections 453 and 1042 by holding that gain otherwise required to be recognized upon receipt of installment payments under section 453 in the absence of a section 1042 election can be deferred for taxpayer having elected section 1042).
[22] *See* I.R.C. § 453B(a) (flush language); *Woody v. Comm'r*, 19 T.C. 350, 354 (1952); *Estate of Henry H. Rogers v. Comm'r*, 1 T.C. 629, 639 (1943).
[23] Consequently, a seller's basis in the seller note is generally equal to the note's stated principal amount.
[24] *See* I.R.C. § 1042(a) (flush language).
[25] *See, e.g., United States v. Davis*, 370 U.S. 65, 73 (1962) (finding value of marital rights wife relinquished determined based on fair market value of property transferred by husband).
[26] Treas. Reg. §1.1001-1(a); *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Bar L. Ranch, Inc. v. Phinney*, 426 F.2d 995, 999 (5th Circuit 1970) (analyzing fair market value of note and accounts receivable).
[27] *See* Treas. Reg. § 20.2031-4; *see also* Rev. Rul. 67-276.
[28] Further, ESOP seller notes typically sit behind senior debt in the capital stack and take the position that would otherwise be filled by mezzanine debt and equity providers. Market evidence indicates that mezzanine debt is commonly underwritten to generate a 10-15%+ gross return, whereas private equity managers commonly employ minimum return thresholds of approximately 20%+ gross IRR. These market return requirements provide a potential benchmark for evaluating the fair market value of seller notes, where the total blended market returns may be in the high teens (e.g. 17-18%). *See* https://education.golubcapital.com/wp-content/uploads/2026/07/An-Income-Alternative-Exploring-Middle-Market-Direct-Lending.pdf, which reflects the typical capital stack for middle market companies with EBITDA between $10 million and $100 million. It reflects first lien / senior debt at 40% of the full capital stack, second lien / subordinated debt at 15% with a target return of 10-12%, and equity at 45% with a target return of 20%+. Using the lowest indicated returns, on a blended basis market returns for seller notes taking the subordinated debt and equity position would target an all-in return of 17.5%. *See also* https://www.pelawreport.com/print_issue.thtml?uri=private-equity-law-report%2Fcontent%2F2026%2Fmay-28-2026, stating mezzanine debt is typically targeting profiles in the range of 11-18%. Consider a traditional seller note with a $10 million principal amount that carries a 6% interest only return for 5 years with a balloon principal payment at maturity; to achieve a target return of 17.5%, the seller note would have to be discounted over 35% from its face amount. To achieve target equity returns of 20%, the discount would need to exceed 40% in this scenario.
[29] *Hegra Note Corp. v. Comm'r*, 387 F.2d 515 (5th Cir. 1967). The Tax Court had rejected both the Commissioner's position that the notes were worth face and the taxpayer's contention that they were worth only 10 to 15% of face.
[30] *Warren Jones Co. v. Comm'r*, 524 F.2d 788 (9th Cir. 1975), rev'g 60 T.C. 663 (1973). The Tax Court had also concluded that the obligation was not a cash equivalent, illustrating that the characteristics relevant to cash equivalency may overlap with those affecting fair market value.

[31] *See Smith v. United States*, 923 F. Supp. 896 (S.D. Miss. 1996). Although arising in the estate tax context, the fair market value analysis is nonetheless instructive. The note in *Smith* bore a stated rate of 6% and was unsecured and uncovenanted. The court concluded a market return of 16% was required based on comparable public debt and taking into consideration lack of registration and marketability, credit shortfalls, and the note's lack of credit protections. The court's valuation represented an approximate 35% discount from the note's stated principal.

[32] This rule interacts with busted section 351 exchange planning where transferors seek to hold less than 80% of Newco immediately after the exchange, while avoiding related-party treatment under section 267 requires the taxpayer to own 50% or less. The available range is narrowed further by the constructive ownership rules of section 267(c), including attribution of stock owned by siblings, a spouse, ancestors, and lineal descendants. I.R.C. § 267(c)(2), (4).

[33] I.R.C. §§ 1276(a)(1), (a)(3), 1278(a)(1). Section 1278(a)(1)(B)(iii) excludes from the definition of a market discount bond an installment obligation to which section 453B applies. However, the seller may well have affirmatively elected out of installment sale treatment. Moreover, even if the seller has not elected out, the taxable exchange with Newco is a disposition under section 1001 that accelerates the deferred gain under section 453B, after which section 453B no longer applies.

[34] If the seller's $3.5 million loss is disallowed under section 267(a)(1), the seller may argue that section 267(d) prevents Newco from recognizing income on the $3.5 million. The market discount rules, however, present a textual obstacle: section 1276 requires recognition of accrued market discount notwithstanding other provisions of the subtitle, generally characterizes the amount as interest, and, when principal is repaid over time, includes the market discount directly in gross income rather than as gain from a subsequent disposition. We are aware of no authority addressing the interaction between sections 267(d) and 1276 in this context.