Number: **200105061**
Release Date: 2/2/2001
U.I.L. 451.00-00

Control Number: TAM-119270-98/CC:ITA:B5

INTERNAL REVENUE SERVICE NATIONAL OFFICE

TECHNICAL ADVICE MEMORANDUM

September 22, 2000
Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer:
Party 1:

Party 2:

Party 3:

Individual A:

Corp 1:

Bank 1:

Bank 2:

Bank 3:

Year 1:

Year 2:

Year 3:

Year 4:

Year 5:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Date 7:

Date 8:

Date 9:

$A:

$B:

$C:

$D:

$E:

$F:

$G:

<u>ISSUES</u>:

1. Whether Taxpayer constructively received $A in Year 1 from the sale of property as provided by sections 451 and 453 of the Internal Revenue Code?

2. Alternatively, whether Taxpayer constructively received $B in Year 1 and $C in Year 2?

3. Alternatively, whether Taxpayer constructively received $A in Year 2?

<u>CONCLUSION</u>:

Taxpayer did not constructively receive or have available for its use any of the $A in Year 1 or Year 2 arising from the Year 3 sale of property.

FACTS:

The outstanding stock of Taxpayer was owned 75% by Party 1 and 25% by Party 2. In Year 4, Taxpayer signed a purchase and sales agreement which provided that on Date 2, it would sell its stock in various corporations to Corp 1. As part of the agreement Party 3 agreed to sell their interests in various partnerships. Taxpayer received $D cash and a promissory note in the amount of $A.

The note named Taxpayer and Party 3 as payees and the principal was due Date 1, with monthly payments of interest only computed on a rate of 10% per annum. The note could only be prepaid up to $B per year after Date 3 or in larger amounts with 12 months written notice to Taxpayer.

Year 3 Letter of Credit

The Corp 1 note was secured by an irrevocable letter of credit issued by Bank 1. Taxpayer required Corp 1 to obtain the letter of credit and Corp 1 was responsible for paying Bank 1's fees. The letter of credit was secured by mortgages on real properties owned by the corporations that were sold to Corp 1. Upon receipt of the stock, Corp 1 entered into two partnerships with Individual A, transferred the stock to the partnerships, and liquidated the acquired corporations. In the event of default Taxpayer had to give Corp 1 and Bank 1 not less than ten days notice before drawing on the letter of credit.

On its Year 3 federal income tax return Taxpayer reported the sale on the installment method. On Date 4, Taxpayer obtained a $E line of credit from Bank 2, pledging as collateral the Corp 1 note and the Bank 1 letter of credit. To evidence the debt, Taxpayer also signed a note to Bank 2 in the same amount that was due on Date 5.

Year 1 Letter of Credit

In late Year 5 Corp 1 and Individual A wanted to end the partnerships and divide the real properties. To do so would require removing the mortgages that secured the Bank 1 letter of credit. Corp 1 approached Taxpayer and Party 3 and inquired about prepaying the note, which would enable Corp 1 to obtain a release of the mortgages. At the request of Taxpayer, an alternative approach was devised whereby, on Date 6, Bank 2 issued a substitute letter of credit to secure the Corp 1 note. The Bank 2 letter of credit in turn was secured by $A of cash that was deposited with Bank 2 by the restructured Corp 1 interests, which included a new partner.

The Bank 2 letter of credit provided that Taxpayer could withdraw amounts when it established that Corp 1 was in default under the terms of the note. The letter of credit also provided that Taxpayer could only transfer and assign it to Bank 2 in connection with the assignment and pledging of the Corp 1 note to Bank 2. An agreement also dated Date 6, entitled "Letter of Credit Reimbursement and Security Agreement" was entered into between Corp 1 and Bank 2 that authorized Bank 2 to purchase U.S. Treasury notes with the $A it had received. The notes bore interest at a rate of 7.125% per annum and matured Date 7. This agreement also provided that the notes would be held in the bank's name to secure the reimbursement obligations of Corp 1 under the letter of credit. In addition, the interest earned on the notes would be used, in part, to pay the interest owed by Corp 1 to Taxpayer on the Corp 1 note. Corp 1 waived to Bank 2 any right or power to direct or control the investment of the $A. Corp 1 waived any right to notice before the seizure or liquidation of the $A collateral and Bank 2 acknowledged that its recourse against Corp 1 was limited to the collateral. Finally, the Bank 2 letter of credit, as secured by the $A, replaced the Bank 1 letter of credit securing the Corp 1 note.

In connection with the above agreement, the Corp 1 note was amended to provide that payment of the principal amount owed was now due on Date 7. Taxpayer also entered into an agreement with Corp 1 in which Taxpayer agreed to be responsible for any costs or fees owed to Bank 2 under the above agreement. Taxpayer also agreed to indemnify any owner of the Corp 1 interests for any federal income tax liability that might arise from an inability to offset interest income earned on the $A account with deductions for interest paid on the Corp 1 note.

<u>Year 2 Letter of Credit</u>

On Date 8, one day before the amended Corp 1 note was due, Corp 1 obtained a new letter of credit in the amount of $A from Bank 3. The Bank 2 letter of credit was canceled. The Corp 1 note was endorsed to Bank 3 as a condition of the issuance of the letter of credit.

This letter of credit also stated that funds could be withdrawn once it was established that the Corp 1 note was in default. Corp 1 signed a "Reimbursement and Security Agreement" with Bank 3 which provided that Corp 1 would deposit $A as security for the issuance of the letter of credit with the amount being invested in time deposits. Corp 1 instructed Bank 2 to transfer the $A of principal and interest on the Treasury notes to Bank 3.

Taxpayer signed a security and pledge agreement indicating it would instruct Corp 1 to make payments directly to Bank 3. Corp 1 signed a Letter of Credit Reimbursement and Security Agreement with Bank 3 stating Bank 3 is the sole beneficiary of, and the only party authorized to draw under, the letter of credit. Corp 1 assigned and pledged to Bank 3 a security interest on the investments, which initially consisted of the cash. Corp 1 authorized the bank to invest in time deposits. Bank 3 had no duty or obligation to Corp 1 with respect to administration, preservation, custody, security or investment of the investments. Bank 3 had no duty to account to Corp 1 on the investments and Bank 3 acknowledged that Corp 1 had no further liability to Bank 3 as the secured obligations were to be paid from the investments.

The Bank 3 letter of credit secured the Corp 1 note and the letter of credit was secured by the investments (time deposits) made by Bank 3. The Corp 1 note was extended to the original due date, Date 1, and the interest rate was changed to LIBID less 25%. Taxpayer furnished Corp 1 with a letter which provided that Taxpayer would be responsible for any costs, fees and expenses claimed to be owing Bank 3 in connection with the reimbursement agreement or letter of credit.

On Date 9, the Bank 3 letter of credit was increased to $F to secure up to $G of accrued but unpaid interest on the Corp 1 note. On the same date, Taxpayer agreed to be responsible for any costs, fees and expenses including legal expenses owed to Bank 3 in connection with the amended agreement.

Taxpayer argues that an installment note secured by a bank standby letter of credit is not a "payment" for purposes of § 453 even though the letter of credit is backed by cash or a cash equivalent. Taxpayer’s position is the Bank 2 letter of credit and the Bank 3 letter of credit were "standby letters of credit" within the meaning of Temp. Reg. §§ 15a.453-1(b)(3)(iii) and 15a.453-1(b)(5), example 7. Accordingly, Taxpayer argues that it meets the language of the regulations dealing with standby letters of credit and therefore there is no payment.

The appeals officer asserts that the taxpayer has received payment in either Year 1 or Year 2 relying on the constructive receipt doctrine. In the alternative the officer argues that a substance over form argument is appropriate under these circumstances and the government is not bound to recognize the form of the transaction.

LAW:

Section 1.451-1(a) of the Income Tax Regulations provides that gains, profits and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting . Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 1.451-2(a) of the regulations provides that a taxpayer constructively receives income in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

Section 453(a) of the Code provides generally that income from an installment sale shall be taken into account for purposes of this chapter under the installment method. Section 453(b) defines an installment sale as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Under § 453(c), the term "installment method" means a method under which the income recognized for any taxable year is the proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

Section 453(f)(3) provides that an evidence of indebtedness of the person acquiring the property will not be considered a payment "whether or not payment of such indebtedness is guaranteed by another person."

The legislative history to § 453(f)(3) indicates that the section was enacted in response to conflicting court opinions. In Griffith v. Commissioner, 73 T.C. 76 (1980), the court held that, by reason of a standby letter of credit used to secure future payment for the sale of a cotton crop, the taxpayer had received full payment in the year of sale. In that case, the taxpayer used certificates of deposit as collateral for the letter of credit. However, in Sprague v. United States, 627 F.2d 1044 (10th Cir.1980), the Court of Appeals held that a letter of credit used to secure payment for the sale of stock did not constitute payment for purposes of the installment sale provisions. In explaining the reasons for enacting the new provision, the Senate Finance Committee indicated that a third party guarantee (including a standby letter of credit) used as security for a deferred payment sale should not be treated as a payment received on an installment obligation. S. Rep. No. 1000, 96th Cong., 2d Sess. 18 (1980).

Section 15a.453-1(b)(3(i) of the temporary regulations provides that the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property ("installment obligation"), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency).... A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include amounts actually or constructively received in the taxable year under an installment obligation.... Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment.

Section 15a.453-1(b)(3)(iii) defines the term "standby letter of credit" as a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit.... A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

Examples (7) and (8) of § 15a.453-1(b)(5) illustrate the treatment accorded a standby letter of credit that secures an installment obligation. In example (7), A sells the stock of X corporation to B for a $1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct lien upon or other security interest in such cash or cash equivalent collateral. The example concludes that receipt of B’s installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

In example (8), the facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of $600,000. To secure fully its $1 million note issued to A, B deposits in escrow $400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B’s installment obligation will be treated as the receipt of payment by A in the sum of $400,000.

<u>ANALYSIS</u>:

No question has been raised as to whether the initial financing of the sale in Year 3 involved a true standby letter of credit. In Year 5, Corp 1 and Taxpayer entered into a restructuring arrangement involving a second standby letter of credit that was designed to accommodate Corp 1's interest in clearing title to the real properties and Taxpayer’s interest in continuing the sale on the installment method. The parties structured an arrangement under which the $A collateral Corp 1 deposited with Bank 2 would be used to pay the principal upon default and to generate interest income that funded the interest payments due on the note. Bank 2 was the issuer of the standby letter of credit, but Corp 1 was not relieved by Taxpayer on the underlying note.

Corp 1 agreed to document the transaction as Taxpayer desired provided there was no cost involved to Corp 1. Taxpayer asserts that it was acting in its own best interests in having certain documents drafted and in paying the expenses of Corp 1, and that those are normal business practices when cash is used as security for a standby letter of credit. Taxpayer acknowledged that indemnifying Corp 1 for any additional income taxes it may incur was not in the normal course of such arrangements, but was necessary because Corp 1 had a concern as to whether its interest income would qualify as investment interest. Taxpayer asserts that Bank 2 would only issue the standby letter of credit for one year, although requested to do so by Taxpayer for a longer period of time. Taxpayer also asserts it was always Taxpayer’s and Corp 1's intent to extend the note to at least the original 10-year due date, and that the restructuring of the transaction with Bank 3 was in furtherance of that intent.

We do not believe the doctrine of constructive receipt is applicable in this case. Section 1.451-2(a) of the regulations provides that a taxpayer constructively receives income in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

In this case Taxpayer was unable to draw upon the security for the standby letter of credit until Corp 1 failed to make the payment on the note when the principal payment matured. Prior to that time the $A was not credited to Taxpayer’s account, or set apart, or otherwise made available so that Taxpayer could have drawn upon it during the taxable year.

We agree that, in enacting section 453(f)(3), Congress intended to allow taxpayers to use the installment method where a standby letter of credit was established by the purchaser. Congress intended to resolve the conflicting court opinions as to whether the use of a standby letter of credit was in reality a payment to the seller.

The Year 1 and Year 2 letter of credit restructuring arrangements come within the parameters of example (7) in § 15a.453-1(b)(5). The use of cash collateral for a standby letter of credit is clearly sanctioned by the example. Furthermore, we believe the Bank 2 and Bank 3 letters of credit are standby letters of credit as that term is generally understood in commercial practice and within the intendment of the definition in § 15a.453-1(b)(3)(iii).

The appeals officer also argues that the "substance over form" doctrine should apply and relies on principles derived from case law decided prior to the enactment of section 453(f)(3). Because we believe the Year 1 and Year 2 letter of credit restructuring arrangements resulted in standby letters of credit or other third party guarantees that are not included within the term "payment" under § 453(f)(3) or § 15a.453-1(b)(3), it is inappropriate to look to those case law principles to determine if, under the facts and circumstances of this case, Taxpayer should be treated as having received payment in Year 1 or Year 2.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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