Tax Treatment of Monetized Installment Sale Transactions

A competent analytical framework for determining what a seller's tax treatment should be upon entering into a monetized installment sale transaction with S.Crow Collateral Corp. has two general components, as follows:

1. As an intermediary installment sale transaction; and
2. As a monetized installment sale transaction.

In addition to those two general components, a further, narrower analytical component is present, if the installment sale amount exceeds $5 million per taxpayer.

Intermediary Installment Sale Transactions

This analytical component is present, because S.Crow Collateral Corp. is an intermediary in the transaction; S.Crow Collateral Corp. purchases from the seller and simultaneously re-sells to a subsequent purchaser, who otherwise (in most instances) would have purchased directly from the seller.

Although relatively few tax practitioners may have had reason to be aware of it, Temp. Treas. Reg. 26 CFR 15a.453-1(b)(3)(i), explicitly provides that an installment seller to a qualified intermediary such as S.Crow Collateral Corp. is not deemed to be in constructive receipt of sale proceeds which the intermediary receives. The Regulation—which applies only to installment sale situations—reads in pertinent part as follows:

> For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)-1(j)(2)(ii) of this chapter.
>
> That § 1.1031(k)-1(j)(2)(ii) states the following:
>
> **(ii) Qualified intermediaries.** Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer.

Note carefully: The Regulation is not saying that the qualified intermediary would otherwise be deemed to be the seller's agent if the Regulation had not been adopted; it is saying that the qualified intermediary will not be treated as the taxpayer's agent, for purposes of the seller's tax treatment.

So, if S.Crow Collateral Corp. functions as a qualified intermediary in its installment transaction with a seller, S.Crow Collateral Corp.'s receipt of sale proceeds from the subsequent buyer will not be attributed to the seller. There is simply no other way to read the Regulation.

Treas. Reg. 26 CFR 1.1031(k)-1(g)(4)(iii) provides the definition of a "qualified intermediary", which, according to that Regulation, has three components:

1. The intermediary is not the taxpayer or a disqualified person (such as a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the previous two years), per Treas. Reg. 26 CFR 1.1031(k)-1(k)); and

2. The intermediary enters into a written agreement with the taxpayer under which the intermediary acquires the relinquished property from the taxpayer and transfers the relinquished property; and

3. The intermediary enters into a written agreement with the taxpayer under which the intermediary acquires replacement property and transfers the replacement property to the taxpayer.

Under Treas. Reg. 26 CFR 1.1031(k)-1(g), it is not necessary that the intermediary be the one who conveys title, if the taxpayer's rights are assigned to the intermediary and the transfers occur pursuant to an agreement to which the intermediary is a party or an agent of a party.

S.Crow Collateral Corp.'s transactions satisfy all three components. S.Crow Collateral Corp. is never the selling taxpayer and is never a disqualified person. Every installment contract provides for S.Crow Collateral Corp. to acquire the asset from the taxpayer and re-sell it. Each of S.Crow Collateral Corp.'s former collateralized installment transactions required S.Crow Collateral Corp. to acquire a replacement asset and later transfer it to the seller. Each of S.Crow Collateral Corp.'s monetized installment transactions requires S.Crow Collateral Corp., at the seller's direction, to arrange for a replacement asset and its transfer to the seller, either (a) by explicit exchange language in the documents or (b) by arrangement for the funding for the acquisition and transfer, or both.

Therefore, since S.Crow Collateral Corp.'s role in its intermediary installment sales is *always* as a qualified intermediary, it is my view that *all* other issues about the transaction as an intermediary installment sale go away. That means that no room remains for arguments about doctrines such as economic substance, step transactions, form over substance, sham transactions, unnecessary intermediary transactions. They are all *gone*. If the Regulation means anything, it means that. (That doesn't mean that those issues would have any validity if the Regulation didn't exist, but it means that they can't have any validity in the face of that Regulation.)

Monetized Installment Sale Transactions

So, if the seller's tax treatment cannot be challenged on the ground that it is an intermediary installment sale, can the seller's tax treatment be challenged on the ground that it is a monetized installment sale?

The largest reported monetization-loan transaction to date was coupled with the 2004 $1.5 billion installment sale of timberland by OfficeMax Incorporated (the former Boise Cascade Corporation). Information about that transaction is found at

http://investor.officedepot.com/phoenix.zhtml?c=94746&p=irol-faq

The most widely known monetization-loan transaction was the one described in the 2012 Internal Revenue Service Chief Counsel Memorandum 20123401F, found at

https://www.irs.gov/pub/irs-lafa/20123401F.pdf

In that Chief Counsel Memorandum, the IRS considered the step-transaction and form-over-substance doctrines and found them not to be applicable, because the parties dealt at arms-length with one another, and all parties considered the loan transaction to be a real transaction. S.Crow Collateral Corp.'s monetized installment sale transactions satisfy *every* point of the Chief Counsel's analysis.

There are those who try to say that the Chief Counsel's analysis doesn't apply to S.Crow Collateral Corp., because:

1. That situation didn't involve an intermediary—but the Memorandum doesn't say so, it's almost certainly untrue (given the financial sophistication required and the immediate re-marketability of the property), and anyway in light of the Regulation discussed above about intermediary installment sales, that fact makes no difference; or

2. The buyer in that situation was "real" and not an intermediary—but the Memorandum does not say that the buyer ever took possession or title, S.Crow Collateral Corp. always undertakes full-recourse 30-year liability on its installment contracts (how much more "real" can one get?), and, again, the presence of an intermediary makes no difference in light of the Regulation discussed above; or

3. S.Crow Collateral Corp.'s installment payments to our seller fund our seller's repayment of the monetization loan—but that was true in the Chief Counsel Memorandum situation, too; or

4. The lenders in the Chief Counsel Memorandum situation may have had more financial strength than the lender with which S.Crow Collateral Corp. works has—a proposition that is remarkable for its irrelevance and for its ignoring the fact that in the Chief Counsel Memorandum situation the installment buyer *deposited the entire purchase price* with one of the banks to fund the repayment of another bank's loan to the seller; or

5. The installment sale in the Chief Counsel Memorandum situation was of agricultural property, so that it was permissible to give the lender a lien on the installment contract that would otherwise be barred by the "pledge rule" that denies deferral of the tax on the gain on sale of business or investment property if the monetization lender is given a lien on the installment contract—but the lender with which S.Crow Collateral Corp. works isn't given

a lien (possessory or otherwise) on the installment contract or any rights in, to or under it, so the pledge rule isn't implicated; or

6. This is too good to be true—to which I say, if good news is hard for you to accept, you're welcome to go elsewhere and enjoy your bad news.

Installment Sales for More than $5M per Taxpayer

If a taxpayer holds installment contracts at the end of the year that were entered into in that year and total more than $5 million, and if the installment sale was a sale of business or investment property, the taxpayer will owe interest to the IRS on the deferred tax liability for that part of the gain which is attributable to that part of the price which exceeds $5 million. Husband and wife are two taxpayers, and so for them the floor installment purchase price at which the interest obligation would arise would be $10 million. Each taxable entity involved in the sale has its own $5 million floor before the interest obligation arises. The interest is deductible.[1]

If the taxpayer's expected after-tax return on investment of the tax money exceeds the after-tax cost of the interest payments to the IRS, the interest cost may not be significant.

There are mechanisms to reduce or avoid the interest obligation, but they should be undertaken because they make business sense and fit with the taxpayer's business objectives, and not merely to avoid the interest cost. Those mechanisms will vary from situation to situation and from taxpayer to taxpayer, and for that reason it is beyond the scope of this paper to address those mechanisms.—Stan Crow

Disclaimer

Nothing in this paper is intended to be, or may be taken to be, tax, legal or investment advice. Interested parties should consult their legal, tax and investment advisers before participating in any transaction.

[1] IRS Publication 537 says, "Corporations can deduct the interest in the year it is paid or accrued. For individuals and other taxpayers, this interest is not deductible." However, the statute, Section 453A(c)(5) says, "Any amount payable under this subsection shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during the taxable year."