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Monetizing Installment Sale Transactions

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In this issue, we will look at two interesting installment sale transactions. The first transaction is described in the facts of Chief Counsel Advice 200423028, which was released on 6/4/04. While the two legal issues addressed in the CCA are rather unremarkable, the facts of the transaction illustrate a creative form of secured, contingent installment sale transaction where the return on the installment obligation was based on public market indexes that could be changed monthly by the installment seller. In the second transaction, Boise Cascade Corporation (NYSE: BCC) arranged for a $3.7 billion sale of its paper, forest products and 2.3 million acres of timberland assets in part through an installment sale that will be monetized without current tax after the transaction closing. Although Congress has acted a number of times over the years to stop the tax-free monetization of installment obligations and to eliminate the income tax deferral benefits for installment sales where the sales price exceeds $5 million, this latter transaction has been structured to escape the application of these rules.

Boise Cascade Corporation

On 7/26/04, Boise Cascade Corp. announced that it had reached a definitive agreement to sell its paper, forest products, and timberland assets for approximately $3.7 billion to Madison Dearborn Partners, Inc., a private equity investment firm located in Chicago, Illinois. [1] Boise Cascade Corp. will change its company and trade name to OfficeMax shortly after the close of the transaction.

Of the assets sold, approximately $1.65 billion of the purchase consideration is being delivered in the form of installment obligations for the timber properties. [2] The balance of the transaction proceeds will be paid in cash. Boise Cascade will use its tax basis in its non-timber properties and approximately $100 million worth of net operating loss carry-forwards to eliminate much of the gain on the cash portion of the transaction. [3] In a conference call, Boise Cascade indicated that its tax basis in the timberlands "is quite low relative to today's market values." [4]

The installment obligations will be secured by standby letters of credit issued by one or more banks. [5]

Liquid or other substantial assets will be deposited by Madison Dearborn Partners as collateral with the issuing banks to secure the banks against a draw under the standby letters of credit. The interest rate payable under the installment obligations will be equal to the rate of return payable on the collateral, less the costs associated with the standby letters of credit. **6** Boise Cascade will then pledge the installment obligation to one or more lending institutions as collateral for a loan equal to 90% of its face amount. **7**

Boise Cascade will reinvest approximately $175 million of the gross proceeds received by Boise Cascade, L.L.C. and its affiliates, the entities formed by Madison Dearborn Partners, to acquire the paper, forest products, and timberland assets.

By way of background, Congress initially acted in 1987 in an attempt to deny the benefits of installment sale treatment to certain large transactions by enacting **Section 453A** . **8** **Section 453A** , as initially enacted, only applied to installment obligations arising from sales of real property used in the taxpayer's trade or business or held for production of rental income. Congress amended **Section 453** in 1988 to apply to any property sold under the installment method, but only if the sales price of such property exceeds $150,000.

Section 453A(c) contains the interest charge rule. This section provides that installment sellers in some large transactions are required to pay an additional tax that is computed like interest and is intended to compensate the Treasury for the delay in the payment of the regular tax on installment gains. Generally, the interest charge applies to gain on all sales for more than $150,000 made during a tax year if, at year-end the taxpayer holds installment obligations from sales during the year in an aggregate principal amount exceeding $5 million. **9** If an interest charge is required to be paid with respect to an installment obligation that arose during a tax year, the interest charge must be paid for any subsequent tax year at the close of which any part of that installment obligation remains outstanding.

Section 453(d) contains the pledge rule. This section generally provides that if an installment obligation is used by the seller as security for a loan, the net proceeds from that loan are treated as a payment received on the installment obligation. **10** A secured loan is a loan secured by an installment obligation to the extent that payment of principal or interest on the loan is directly secured under the terms of the loan, or other underlying arrangements, by an interest in the installment obligation. **11** An arrangement that gives the taxpayer the right to satisfy an obligation with an installment note is treated in the same manner as the direct pledge of the installment note.The balance of the deferred tax would be subject to the interest charge rule of **Section 453A(c)** . **12**

If these rules applied to the installment obligations received by Boise Cascade, it would recognize a substantial portion of the otherwise deferred taxable gain upon the pledge of the obligations to secure its borrowing. The balance of the deferred tax would be subject to the interest charge rule of Section 453A(c). **12a** However, because Boise Cascade structured the installment obligations as consideration for only the timberland, it intends to take advantage of an exception for farm property.

Specifically, **Section 453A(b)(3)** excludes from application of the interest charge and pledge rules any obligations arising from the disposition of certain personal use property, property used or produced in the

trade or business of farming as defined in **Section 2032A(e)(4)** or (5), and certain timeshares and residential lots. In the case of Boise Cascade, it is the exception for property used or produced in the trade or business of farming that provides the apparent exception from the interest charge and pledge rules.

Sections 2032(A)(e)(4) and (5) provide:

> **(4)Farm.** The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and *woodlands.*
>
> **(5)Farming Purposes.** The term "farming purposes" means-
>
> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
>
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
>
> (C)(i) the *planting, cultivating, caring for, or cutting of trees*, or
>
> (ii) *the preparation (other than milling) of trees for market.* (Emphasis added.)

It would appear that Boise Cascade timber and the land on which the timber is situated qualify as being used for farming purposes. **13** This seems reasonable since the timber is either being planted, cultivated, cared for, or cut. **14** Boise Cascade certainly appears to be taking that position and it seems reasonable enough. **15** This should permit Boise Cascade to monetize 90% of the installment obligations without any current tax. Moreover, the interest charge rule will be inapplicable. Since the installment obligation is credit enhanced by bank standby letters of credit (which are themselves presumably secured by liquid or other substantial assets), the borrowing should be on fairly advantageous terms.

CCA 200423028

In CCA 200423028, the IRS reviewed two separate installment sale transactions in which a purchaser issued nonnegotiable, nonassignable contingent installment obligations in exchange for two lottery prize

receivables. **15a** In its analysis, the IRS detailed a transaction structure offered by a factoring organization, pursuant to which "individuals who have the right to receive certain discrete, periodic payments of cash may sell all or a portion of the future periodic payments to [the organization] or a trust that [the organization] sponsors in exchange for non-negotiable, non-assignable installment notes." One of the most unique aspects of the structure was highlighted by the IRS when it noted "that the amount of payments Taxpayers would receive under the notes would be determined with reference to 'investments selected by' Taxpayers." The IRS also pointed out that the taxpayers could "change the investment menu on a monthly basis and that the obligations were credit enhanced by standby letters of credit." **16**

It was also interesting to observe that in the IRS's recitation of the facts and circumstances incident to the transactions under review, it was specifically noted that each of the lottery prizes purchased by the organization in connection therewith included a then-currently exercisable "cash out option." **17** Pursuant to the cash out option, the holder of the lottery receivable could request an immediate lump sum payout (in lieu of periodic payments). In these two separate transactions, the holders of the receivables chose to sell their receivables to the organization in exchange for an installment obligation and forgo the option of obtaining an immediate lump sum payout from the state. The facts of the CCA indicate that the organization did, in fact, exercise the cash out options within a short time of acquiring the lottery receivables and was in receipt of payment thereafter.

Note that the ability of the seller to request prompt payment (i.e., within ten days) did not preclude such individual from disposing of the lottery receivable in exchange for an installment obligation, thereby enabling such individual to effectuate a deferral of income recognition. This is consistent with **Section 451(h)** , which generally ignores the short term right to elect to receive a lump sum lottery prize payment for constructive receipt purposes. This is also consistent with existing constructive receipt authorities. **18**

The ability to issue an installment obligation, the return on which is based on market indexes and other public securities references finds much support in case law. At least two courts have expressly approved the direction of investments of escrowed amounts in securities and rejected application of the constructive receipt doctrine where the sellers could not access the money currently. For example, in *Murray*, **19** an installment seller was permitted under the terms of the sale to direct the investment of escrowed funds into any NYSE securities. In *Murray*, a cash escrow had been set up to ensure compliance by the seller with a covenant not to compete and to otherwise guarantee payment. The seller was entitled to receive any income earned on such securities and all appreciation, but was subject to the risk of any loss from declines in market value. The court held that the transaction qualified as an installment sale and that the seller was not in constructive receipt of any of the invested funds prior to actual receipt. **20**

Similarly, in *Anderson*, **21** an installment seller was permitted to direct the investment of certain escrowed funds in U.S. government securities or any securities listed on the NYSE, AMEX, the San Francisco Stock Exchange, and/or the Los Angeles Stock Exchange. The sellers were entitled to payments of all interest and net profits from the investment of the escrowed funds on a semi-annual basis. The escrow had been set up to secure certain representations and warranties of the sellers. The

sellers bore substantially all risk of loss from the investments and were entitled to substantially all of the appreciation. The IRS asserted that the sellers were taxable on the placement of the money in escrow based upon their control over the amounts. In rejecting the IRS's claim, the Tax Court stated:

> On the one hand, we have the following factors weighting the balance toward respondent's position: The full purchase price was paid for the stock, some $500,000 of which was set aside to protect the purchaser; the fund could be reached by the purchaser, in the event the liabilities materialized, only with the consent of petitioners; the fund was subject to being, and in fact was, tapped to reimburse petitioners for the expenses incurred in prosecuting mining patents; petitioners received all the income from the fund; they could direct the investment of the fund in recognized securities including those listed on the Los Angeles and San Francisco exchanges. Thus, in effect, it would be possible apparently for petitioners to utilize the funds as capital for a new corporate venture undertaken by them.
>
> However, we must recognize that the following facts shift the balance toward the petitioners: The fund was not unqualifiedly petitioners', i.e., just as Buyer could not freely use the funds, neither could the petitioners; the fund might never belong to petitioners if the liabilities materialized and, in fact, Buyer filed a letter with the bank, thus making claim to $225,000 of the fund; and as of the date of the trial, the bank was still holding this amount. This qualified control of the fund and income is particularly demonstrated by the provision that the bank withhold income if the fund dropped below $500,000. It appears that income was in fact withheld for that very reason. *Although the petitioners had a free hand in investment of the money, still they lacked the ultimate incident of ownership, viz., the power simply to pick up the money, put it into their pockets, and spend it at will and for whatever they deemed advisable.* (Emphasis added.) **22**

Also, commentators have noted that the "installment sale rules impose no restrictions on the index used to determined the taxpayer's return. ... For instance, the installment obligation ... could provide that the taxpayer's return is based on the S&P 500 index (or based on the taxpayer's favorite hedge fund) and the installment sale principles would appear to provide support for the proposition that the taxpayer is not the tax owner of the trading account used to hedge the purchaser's obligations under the note." **23**

In summary, these facts highlight that installment obligations can provide a market based return which can be periodically changed. This can eliminate a factor from the decision whether to pursue a cash sale or not. That is, in a traditional installment sale, the seller will often get only a fixed annual return, whereas under a variable installment obligation or a cash sale, the seller can obtain a market based return on the after-tax cash proceeds or on the pre-tax amount under the variable installment obligation. **24**

Conclusion

Both of the structures discussed above suggest some interesting installment sale transactions that can be utilized in appropriate circumstances. A common element in both-the presence of a standby letter of credit-enables sellers to generally ignore the credit risk of the purchaser and hence defer tax without taking on any credit risk. Moreover, by obtaining a return on the installment obligation equal to the return generated by the collateral for the standby letter of credit, the seller can obtain a market based return on the entire pre-tax sale amount.

1 See Boise Cascade Corp. Form 8-K SEC File No. 001-05057 (7/29/04). Of the $3.7 million in gross sales proceeds, BCC has indicated that it expects to use approximately $2.2 to $2.3 billion of the net proceeds to pay down debt and meet other obligations and to distribute the remaining net proceeds to its shareholders through common and/or preferred stock buybacks and/or cash dividends.

2 See section 3.1 of the Asset Purchase Agreement, attached to the Boise Cascade Corp. Form 8-K SEC File No. 001-05057 (7/29/04) (hereinafter, the "Asset Purchase Agreement").

3 See statements of Theodore Crumley, Chief Financial Officer, of Boise Cascade, contained in Exhibit 99 of the Boise Cascade Corp. Form 8-K SEC File No. 001-05057 (7/29/04).

4 *Id.*

5 See section 4.1.2 of the Asset Purchase Agreement.

6 *Id.* Standby letters of credit secured by liquid assets are specifically permitted by the applicable Treasury regulations. Temp. Reg. 15A. 453-1(b)(3); see also **TAM 200105061** (IRS approved installment sale treatment for a buyer's installment obligation that was secured by a standby letter of credit issued by a financial institution. The buyer pledged cash and government securities to the bank to secure the buyer's reimbursement obligations to the bank under the letter of credit issuance documents).

7 See statements of Theodore Crumley, Chief Financial Officer, of Boise Cascade, contained in Exhibit 99 of the Boise Cascade Corp. Form 8-K SEC File No. 001-05057 (7/29/04). It has been suggested that a greater amount was not borrowed so as to prevent a constructive sale or other disposition of the installment obligation under pre- **Section 453A** authorities in the installment sale area. See Willens, "Boise Cascade's Excellent (Divestiture) Adventure-A Case Study," 101 J. Tax'n 151 (2004).

8 P.L. No. 100-203, section 10202(e)(1), 101 Stat. 1330-38 (1987). Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.

9 The interest charge payable on an installment obligation is an amount equal to the "applicable percentage" of the deferred tax liability multiplied by the IRS's underpayment rate in effect for the month in which the tax year ends. **Section 453A(c)(2)** . The "applicable percentage" for all obligations arising during a tax year is determined by dividing the portion of the aggregate face amount of such obligations outstanding as of the close of the tax year in excess of $5 million by the aggregate face amount of such obligations arising in and outstanding at the close of the tax year. **Section 453A(c)(4)** . Once the applicable percentage is determined, this percentage does not change as payments on the obligations are made in subsequent years.

10 Section 453A(d)(1) .

11 Section 453A(d)(4) .

12 *Id*.

12a It is worth noting that commentators have pointed out that the use of the phrase directly in Section 453A leaves the pledge rule open to creative avoidance strategies. Rubin&Cejudo, *Getting Out of the Deal: Creative Exit Strategies*, 496 PLI/Tax 505 (2001) (presenting arguments for and against treating a pledge of an interest in an entity as a pledge of an underlying installment obligation); B. Bittker&L. Lokken,*Federal Income, Estates and Gifts* ¶106.1 ("by limiting the [pledge] rule to directly secured arrangements, however, Congress left the IRS defenseless against artful avoidance devices." These authors also cite to legislative history to proposed but unenacted language which explained that the regulations could address a situation, for example, "where a parent corporation has a wholly-owned subsidiary that holds primarioy installment obligations, and the parent pledges the stock of the subsidiary as collateral for a loan").

13 See **Reg. 20.2032A-3(g), Ex. 7** (discussing how the **Section 2032A** material participation requirement is applied to a "tree farm."); Estate of Rogers, **TC Memo 2000-133** RIA TC Memo ¶2000-133 79 CCH TCM 1891 (timber property valued under **Section 2032A**); Estate of Sherrod, **82 TC 523** (1984) (estate allowed to specially value timberland, crop land, and pasture land under **Section 2032A**), *rev'd on grounds not relevant here*, **56 AFTR 2d 85-6594** 774 F2d 1057 85-2 USTC ¶13644 (CA-11, 1985); Jurinski, "Special Use Valuation Can Reduce Estate Tax For Timber Owners," 5 Valuation Strategies 34 (Jan/Feb 2002).

14 For detailed discussion of the timber business and the general tax rules associated therewith, see

Burnett, 610 T.M., "Timber Transactions"; Bellatti, *Estate Planning for Farms and Other Family-Owned Businesses*.

15 But see **Section 2032A(e)(13)** which requires a special election for standing timber to be treated as part of the farm realty, and not a crop, for valuation purposes.

15a There appear to be no issues with a lottery prize qualifying as property for installment sale purposes. **119 TC 1** (2002) (the "right to receive future annual lottery payments is property in the ordinary sense of the word."); **54 TC 1083** (1979), *aff'd* 478 F.2d 1049 (CA-9, 1973).

16 The two issues addressed in the CCA were (1) whether the organization's subsidiary both acquired the lottery prize and issued the installment obligation (required by **Reg. 15a.453-1(b)(3)** to be done by the purchaser of the property) or whether the person who acquired the lottery prize (i.e., the purchaser) was different than the entity that issued the installment obligation and (2) who was entitled to recover the income taxes withheld by the state lottery commission with respect to post sale lottery prize payments. In the case of the first issue, the IRS ruled that the subsidiary had both issued the installment obligation and acquired the lottery prize, and hence the requirement that an installment obligation be issued by the purchaser was met. On the second issue, the IRS ruled that the subsidiary, not the seller, was entitled to credit for the taxes withheld by the state lottery commission.

17 Presumably, this referred to the window period, which expired 12/31/00, under which states offered lottery prize winners who were receiving payments on a periodic basis the option to elect a lump sum payment prior to such date without being in constructive receipt of the full value of the lottery prize. See Section 5301(b)(2) of PL 105-277, which provided that, for an 18-month period commencing on 7/1/99 and continuing to 12/31/00, lottery prize winners receiving payment in the form of an annuity could be given the right to elect a lump-sum distribution equal to the present value of the remaining annuity payments without being in constructive receipt of any amount. For a complete discussion of the application of the constructive receipt doctrine to lottery prize winners, see Aghdami, "The Morning After: Tax Planning for Lottery Winners," 90 J. Tax'n 228 (1999).

18 Veit, **8 TC 809** (1947); Veit, PH TCM ¶49253 8 CCH TCM 919 (1949); Oates, **18 TC 570** (1952), *aff'd* **44 AFTR 535** 207 F2d 711 53-2 USTC ¶9596 (CA-7, 1953); Olmstead Inc. Life Agency, **9 AFTR 2d 1699** 304 F2d 16 62-2 USTC ¶9511 (CA-8, 1961); Martin, **96 TC 814** 13 EBC 2400 (1991).

19 **28 BTA 624** (1933).

20 It should be noted that the installment obligation in CCA 200423028 bears many similarities to a private annuity. The tax principles applicable to private annuities are conceptually similar to those applicable to installment sale obligations and permit realized gain to be deferred over the term of the

annuity. **Rev. Rul. 69-74, 1969-1 CB 43** . The legislative history of the installment sales rules indicates that they do not "deal directly with" private annuities. S. Rep. No. 1000, 96th Cong., 1st Sess. 12 n.12 (1980), reprinted in 1980-2 CB 494, 500. See also **Reg. 15a.453-1(c)** (dealing extensively with installment sales under contracts providing contingent payments, apparently without affecting private annuities). The IRS has set forth factors which distinguish private annuities and installment obligations. See **GCM 39503** (5/19/86). Under this GCM, an obligation is an annuity if it is to be paid over the life expectancy of the seller. Otherwise, the obligation is generally an installment sale. Since the installment obligation at issue in the CCA was for a fixed term, presumably it should be treated as an installment obligation and not as an annuity.

21 **TC Memo 1961-139** PH TCM ¶61139 20 CCH TCM 697 (1961).

22 But see Lustgarden, **47 AFTR 2d 81-1113** 639 F2d 1208 81-1 USTC ¶9273 (CA-5, 1981) (ability to change investments cited as significant factor in finding taxpayer in constructive receipt of escrow and trust funds controlled by taxpayer's son). cf., **Ltr. Rul. 9433030** (requiring various representations regarding lack of investment control by life insurance policy owner as a pre-condition to or rulings on owner control under **Section 817(h)**); see also, **Rev. Rul. 77-85, 1977-1 CB 12** ; **Rev. Rul. 80-274, 1980-2 CB 27** ; **Rev. Rul. 81-225, 1981-2 CB 13** (generally, under these revenue rulings, in order for the insurance company to be considered the owner of the assets in a separate account, control over individual investment decisions must not be in the hands of the policyowners); Investment Annuity, Inc. et. al. v. Blumenthal, **40 AFTR 2d 77-6151** 442 F Supp 681 77-2 USTC ¶9723 (D.D.C. 1977) (declaring **Rev. Rul. 77-85** invalid), reversed on procedural grounds; Christopherson, **55 AFTR 2d 85-407** 749 F2d 513 84-2 USTC ¶9990 (CA-8, 1984) (court, citing **Reg. 1.451-2(a)** used a constructive receipt analysis to hold the policyowner taxable on separate account income invested under the control of the policyowner.).

23 Miller, "Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects," 51 Tax Law. 279, 301 (1998).

24 This structure raises a host of other issues that should be considered, including the possibility of structuring the standby letter of credit to be variable in amount to track the amounts due, the possibility that the obligation could be bifurcated into a fixed rate obligation coupled with an equity swap (see, e.g., **Reg. 1.446-3(g)(4)** (bifurcating a swap with a significant non-periodic payment into a loan and an on-market swap)) and, if the issuer elected to hedge its exposure under the obligation by purchasing the underlying index, how any resulting income and gains therefrom might be accounted for.

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