INTERNAL REVENUE CODE SECTION 453: "MONETIZING" THE TAX DEFERRED INSTALLMENT SALE OF FARMLAND AND FARM COMMODITIES

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I. SETTING THE STAGE

The use of deferred payment reporting on sales of farmland and farm commodities has existed in various forms since its inception in 1918.[1] For farmers who use the cash method of accounting, deferred payment has been a tax strategy utilized to defer the reporting of income into the following tax year. The deferred payment of farmland sales is commonly referred to as an installment sale.[2] The deferred payment on personal property, such as grain and livestock, also qualifies for installment sale reporting.[3]

The term "monetize" refers to the "process of turning a non-revenue-generating item into cash."[4] Thus, the monetization of the deferred payment is simply converting the installment sale of farm real estate or the deferred sale of farm commodities (such as grains and livestock) into cash.[5]

The monetization of installment sales transactions has historically been a tax strategy reserved for multimillion-dollar transactions.[6] These transactions were exclusively orchestrated by the

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1. *See* RICHARD R. POWELL, POWELL ON REAL PROPERTY § 10B.04[2] at 3 (2018) (discussing the Treasury Department's promulgated regulations, which, for the first time, allowed installment reporting in essentially the same form as is currently available under I.R.C. § 453).
2. NEIL E. HARL, FARM INCOME TAX MANUAL 2 (2018).
3. *Id*. (citing Rev. Rul. 58-162, 1958-1 C.B. 234).
4. INVESTOPEDIA, https://www.investopedia.com/terms/m/monetize.asp (last visited Jan. 21, 2019).
5. *See* Scherbart v. Comm'r, 453 F.3d 987, 989 (8th Cir. 2006) (stating that the sale of farm commodity corn qualified for installment sale reporting).
6. *See* Boise Cascade Corp., Asset Purchase Agreement (Form 8-K) (July 29, 2004) (discussing Boise Cascade Corporation's sale of paper, forest products, and timberland assets for $3.7 billion dollars to Madison Dearborn Partners, Inc., with nearly $1.65 billion dollars of sale consisting of a monetized installment sale transaction for the timber properties); *see also* Santiago Solari, *Can MeadWestVaco keep up the cash flow?,* MARKET REALIST (Feb. 6, 2015, 7:07 AM https://marketrealist.com/2015/02/can-meadwestvaco-keep-cash-flow (discussing MeadWestvaco's sale of forest lands to Plum Creek

formerly Big Eight accounting firms.[7] A representative sample of the Monetized Installment Sales is set forth below:

Size	Corporate Entity	Transaction Date	Auditor at Time of Transaction
$ 617 M	Kimberly Clark	9/30/1999	Deloitte & Touche LLP
$ 37.90 M	Glatfelter	2003	Deloitte & Touche LLP
$ 22.90 M	Rayonier	3/1/2004	Deloitte & Touche LLP
$ 1.47 B	Office Max	10/29/2004	KPMG
$ 43.25 M	GREIF, Inc.	5/31/2005	Ernst & Young LLP
$ 4.80 B	International Paper	4/4/2006	Deloitte & Touche LLP
$ 744 M	MeadWestvaco	12/6/2013	PricewaterhouseCoopers
$ 183 M	The St. Joe Company	3/5/2014	KPMG

The complexity and cost of structuring these transactions has historically put them beyond the reach of small to midsized farmers. However, recent standardizations of the monetization documentation have made the monetization of deferred payment transactions for the sales of farms and agricultural commodities accessible to nearly all farmers.[8] As a result, the monetization of the deferred sale is no longer reserved for multimillion and billion dollar transactions.

Traditionally, the seller structured the installment sale of farmland so that the seller received a series of equal annual payments over ten, fifteen, twenty, or thirty years. This was designed, in part, so the seller could spread out income taxes on the sale of appreciated farm assets over the life of the contract. So long as the seller received at least one payment from the sale after the close of the taxable year of the sale, the transaction was classified as an installment sale under Internal Revenue Code ("Code") § 453.[9] The farm seller only had to report and pay income taxes for the proportion of the payments received in that year relative to the overall gain on the sale.[10]

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with 860 million dollars paid with a monetized note through a secured financing arrangement to receive 774 million dollars in proceeds).

7. *See* Solari, *supra* note 6; Kimberly-Clark Corp., Annual Report (Form 10-K) (Mar. 14, 2003); Greif, Inc., Current Report (Form 8-K) (June 6, 2005); Plum Creek Timber Co., Inc., Quarterly Report (Form 10-A) (Aug. 10, 2000).

8. *See FAQ,* Farmers First Trust, https://www.farmersfirsttrust.com/faq (last visited Jan. 21, 2019) (standardizing the process and documentation for the "Monetized Deferred Payment Transaction").

9. I.R.C. § 453(b) (2012). "The term 'installment sale' means 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." *Id*.

10. *Id*. The statute provides, in relevant part:

> For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is

Contrast this traditional installment sale transaction with a monetization of an installment sale transaction that is available when selling farms and farm products. For illustration purposes, this article segregates this monetization of an installment sale transaction into four steps.

A. Step One

When monetizing an installment sale, the transaction remains a sale of farmland or farm commodities with an installment contract. Thus, we have a traditional agricultural seller and purchaser with terms of the sale that appear very similar to the traditional installment sale transaction. However, the contract must provide that the purchaser may assign its obligations to make installment payments to a third-party obligor. The purchaser pays the entire purchase price less proration, fees and costs at the preliminary closing. When the obligations are assigned by the purchaser to the obligor, the obligor holds the seller's closing proceeds, which allows the obligor to complete the payment to the seller in accordance with the terms of the installment sale contract. Note that this preliminary closing results in the purchaser getting immediate title to the purchased asset or assets, but the funds are not delivered to the seller or to an agent of the seller until the end of the contract term. The funds remain under the custody of the obligor, who will make payments to the seller in accordance with the installment contract until the end of the contract term. The contract term typically runs fifteen, twenty, or thirty years.

This transaction looks somewhat similar to a like-kind exchange under Code § 1031.[11] Similar to how a qualified intermediary steps in to complete the purchase of like-kind property in a § 1031 exchange, the obligor must step into the purchaser's shoes. The documentation makes clear that the obligor is taking receipt of the funds to fulfill the installment payment contract and is stepping into the shoes of the purchaser through an assignment of the purchaser's obligation to complete the transaction pursuant to the installment contract. Immediately following the preliminary closing, the purchaser is out of the transaction and the obligor steps into the purchaser's shoes to fulfill the purchaser's obligation to complete the payments.

> that 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.

Id.

11. I.R.C. § 1031 (2012).

B. Step Two

Unlike traditional installment sales contracts, in the monetization of an installment contract the contract typically provides for a one-time payment of the principal balance to the seller in ten, twenty, or thirty years. In addition, the contracts provide for monthly or quarterly interest payments to the seller. To memorialize these regular interest payments and interest terms, a nonnegotiable promissory note is provided to the seller. The obligor will deposit the funds in a segregated investment account that is comprised of United States Treasury bonds. Since the obligor is required to have the purchaser's funds available to complete the transaction at the end of the contract term, it is essential that as much of the investment risk as possible be removed from the transaction. The obligor will pay the interest on the invested funds to the seller in accordance with the terms of the nonnegotiable promissory note. These funds, which are held in United States Treasury instruments, are used to secure an irrevocable standby letter of credit that is provided to the seller to guarantee performance under the installment sales contract by completing all the nonnegotiable promissory note payments.

C. Step Three

Once the nonnegotiable promissory note and the corresponding standby letter of credit are in the seller's hands, the asset (i.e., the promissory note) and the collateral (i.e., the standby letter of credit) are in place for the seller to obtain a loan for nearly the entire installment sale contract price. Since this loan is 100 percent collateralized, the seller can borrow at very favorable interest rates that are slightly above the amount that the seller would receive on the nonnegotiable promissory note. The loan, which is obtained by the seller for nearly the entire sales amount, less transaction fees and costs, is not considered sales proceeds that will trigger income taxes. Rather, the monetization (i.e., getting cash from a loan) for the entire value of the net sales price in the installment sales will receive favorable installment sale income tax reporting under Code § 453.[12]

D. Step Four

Upon the ultimate closing at the end of the installment sales contract, the transaction is closed out. The purchase proceeds held by the obligor are then delivered to the seller in exchange for return and cancellation of the nonnegotiable promissory note. In turn, the seller uses the proceeds to retire the loan with the lender. Once the transaction

12. I.R.C. § 453 (2012).

is closed, the seller will have to report gain on the sale proceeds in excess of seller's basis.[13]

The economic impact to a seller of monetizing the installment sale is substantial. The installment sale permits the sale of property used or produced in the business of farming (i.e., farmland or farm commodities) while enabling the seller to immediately receive the entire sales proceeds, less transaction costs and fees. In addition, the seller defers the income taxes over the duration of the installment sale term. On a monthly or quarterly basis, the seller has payment obligations on the loan, which are offset by the interest received from the obligor. The net interest payments paid by the seller on the loan is, in effect, the spread between the net earnings on the interest received from the obligor and the interest paid on seller's loan from the lending institution.

A monetized deferred sale of farmland or farm commodities with a deferred tax payment, unavoided, for years, even decades, gives the seller tremendous leverage and the opportunity to earn a significant return on the taxes deferred and on the sale proceeds. Since the seller does not have to pay the income taxes for the duration of the contract, the seller has the opportunity to invest the entire loan proceeds, approximately equal to the sales proceeds, instead of just investing the net after-tax proceeds over the contract term.

Another advantage to the seller of the monetized installment sale is that the seller is not subject to the credit risks of the purchaser. Thus, the seller avoids the risk of the purchaser having credit problems or backing out of the purchase if the value of the purchased asset (i.e., land or commodities) declines.

To understand how the monetized installment sale of farmland or farm commodities works, it is necessary to begin by reviewing Code § 453. Because the monetization transaction is the final step in an installment sales transaction, compliance with, and a thorough understanding of, § 453 is essential. Some historical background helps illustrate how installment sales reporting has evolved over the past 100 years. In addition, the history of § 453 makes it clear that this strategy is not new. A review of regulations, Internal Revenue Service ("IRS") memoranda, and case law discussing installment sales and their monetization is necessary to fully understand the requirements to successfully implement this tax savings strategy.

13. I.R.C. § 453(c); 26 C.F.R. § 15A.453-1(b)(1) (2018).

II. LEGISLATIVE HISTORY OF INTERNAL REVENUE CODE SECTION 453

The initial enactment of the installment sales method of reporting income occurred in 1918.[14] Instantly, farmers began using the installment sales method to report their income from the sale of farm machinery.[15] The United States Department of the Treasury promulgated regulations that provided clarity for Code § 453 in 1918.[16] The foundation of these initial regulations has existed since that time. However, in 1925, in *B.B. Todd, Inc. v. Commissioner*,[17] the United States Board of Tax Appeals declared the 1918 regulations to be invalid because of the inconsistencies with the recently passed statute.[18] Therefore, the United States Congress adopted § 212(d) of the Revenue Act of 1926 to address the concerns raised by *B.B. Todd, Inc.*[19]

For over fifty years, the installment sales method of reporting remained fairly consistent. However, the United States Congress passed the Installment Sales Revision Act of 1980*,* which restructured the installment sales provisions.[20] The Installment Sales Revision Act of 1980 divided the installment rules into three separate code sections.[21] Section 453 covered the sales of real estate and casual sales of personal property.[22] Section 453A covered dealer sales of personal property.[23] Section 453B covered the disposition of installment obligations.[24] The changes also reversed installment sales reporting procedures to automatically apply installment reporting to all qualified sales unless the taxpayer affirmatively opted out of the installment reporting method.[25]

The 1980 revisions, which were critical to the availability of monetized installment sales, overruled the so-called two payment rule that

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14. *See* POWELL, *supra* note 1 (discussing the Treasury Department's promulgated regulations which, for the first time, allowed installment reporting in essentially the same form as is currently available under § 453).
15. *See* DOYLE, TAXATION OF INCOME DERIVED FROM INSTALLMENT SALE, 4 TAXES 53 (1926).
16. *See* POWELL, *supra* note 1 .
17. 1 B.T.A. 762 (1925).
18. B.B. Todd, Inc. v. Comm'r, 1 B.T.A 762, 766 (1925).
19. Revenue Act of 1926 § 212(d), 44 Stat. 9.
20. The Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 96th Cong. 2d Sess.
21. *Id*.
22. *See* I.R.C. § 453 (2012).
23. *See* I.R.C. § 453A.
24. *See* I.R.C. § 453B.
25. *See* The Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 96th Cong. 2d Sess. (repealing the need for an affirmative election to be filed to use the installment method of reporting).

denied installment reporting when the sales price was paid in a one-time lump sum in a tax year subsequent to the year of sale.[26] Previously, in *Baltimore Baseball Club v. United States*,[27] the court concluded that the installment concept by its very name required two or more payments.[28] Now, a single payment in subsequent years is not considered payable in installments and therefore not available for installment reporting.[29]

While the 1980 repeal of the two-payment rule benefitted the taxpayer, it added a new restriction on installment method reporting for related party sales.[30] Under the 1980 revisions, the taxable gain would have to be reported if the property was resold by the related party within two years of the initial transfer.[31]

Additional restrictions were imposed by the Tax Reform Act of 1986.[32] The 1986 legislation denied installment reporting to dealers that sold property under revolving credit plans.[33] Congress reasoned who revolving credit plans generated a continuous flow of cash and did not pose a liquidity problem that might justify favorable installment method reporting.[34] These restrictions were expanded in 1988 when Congress passed the Omnibus Budget Reconciliation Act of 1987, which further restricted the installment method to dealer sales of real property.[35]

Most of the key changes in the Tax Reform Act of 1986 were contained in the repeal of old version of Section 453A and the passage of new Section 453A. It is key to monetized installment sales transactions that the new Section 453A expressly exempted property *used or produced in the trade or business of farming*.[36]

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26. *See* Balt. Baseball Club v. United States, 481 F.2d 1283, 1287 (Ct. Cl. 1973) (discussing the "two-payment rule").

27. 481 F.2d 1283 (Ct. Cl. 1973).

28. *Balt. Baseball,* 481 F.2d at 1286.

29. *Id*.

30. *See generally* Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), aff'd 52 T.C. 888 (1969). The court permitted the installment method of reporting on a transaction between parent and trust established for benefit of parent's children. *Id*.

31. *See* I.R.C. § 453(e).

32. Tax Reform Act of 1986*,* Pub. L. No. 99-514, 99th Cong. 2d Sess.

33. *See id*. (adding I.R.C. §453(k)(1)).

34. *See* JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, S. REP. NO. 490-91 (1987).

35. *See* I.R.C. § 453A (2012).

36. *See* I.R.C. § 453A(b)(3) (2012) (exempting from the restrictions of §453A "any property used or produced in the trade or business of farming. . .") (emphasis added).

III. DEFINITIONS AND STATUTORY FRAMEWORK UNDER INTERNAL REVENUE CODE SECTION 453

Subsections 453(a)-(c) of the Code lay out the definitions and general framework.[37] Subsection 453(a) states the general rule that income from an installment sale is accounted for under the installment method.[38] Subsection 453(b) defines installment sale as the disposition of property if at least one payment is received after the close of the taxable year of the sale.[39] Lastly, subsection 453(c) defines installment method as one in which the income recognized for any taxable year is the portion of the total payments received in that year.[40]

Section 453(f)(3) is essential for the viability of monetized installment sales reporting because it provides that "the term 'payment' does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person)."[41] Thus, this subsection provides the statutory authority for the use of a standby letter of credit as security in a monetized deferred payment transaction without treating the standby letter of credit as a payment received on the installment obligation. In applying Code § 453(f)(3) to monetized installment sales transactions, the obligor or other financial institution providing a standby letter of credit to the seller, as security for the payment and fulfillment of the installment obligation in future years, can do so without disallowing installment sales reporting.[42] Alternatively stated, even in cases where a standby letter of credit is received by the seller as collateral, the seller can still qualify for installment sales reporting of income.

It is essential in a monetized installment sale transaction that the standby letter of credit meets the IRS regulations requiring all standby letters of credit to be nonnegotiable and non-transferable, except together with the evidence of indebtedness which it secures.[43] The regulations go on to require that the letter of credit be issued by a bank or other financial institution, which serves as a guarantor of the evidence of indebtedness that is secured by the letter of credit.[44] The regulations go on to state that a letter of credit is not a standby letter

37. *See* I.R.C. § 453(a) (2012) ("General rule"); I.R.C. § 453(b) ("Installment Sale Defined"); I.R.C. §453(c) ("Installment Method Defined").

38. I.R.C. § 453(a) .

39. *See* I.R.C. § 453(b) (defining installment sale).

40. *See* I.R.C. § 453(c) (defining installment method).

41. I.R.C. § 453(f)(3) (emphasis added).

42. *See generally* I.R.C. § 453(f)(3).

43. 25 C.F.R. §15a.453-1(b)(3)(iii) (2018).

44. *Id*.

of credit if it may is drawn upon in the *absence of default* on payment of the underlying indebtedness.[45]

In evaluating the standby letter of credit in a monetized installment sales transaction, it is not uncommon that the bank letter of credit is drawn upon, even in the absence of default. If it may be drawn upon even in absence of default, the taxpayer is deemed to have taken constructive receipt. If the seller is deemed to have constructive receipt of the proceeds, the installment sales reporting (i.e. tax deferral) of the gain is not available and the seller must immediately recognize all the gain.[46]

IV. DEFINITIONS AND STATUTORY FRAMEWORK UNDER SECTION 453(A)

The Installment Sales Revision Act of 1980 was the initial enactment of Code § 453A.[47] The further restrictions under § 453A, enacted in 1988, were designed to deny the benefits of installment sale treatment on large transactions.[48] Specifically, all transactions over $150,000 were subject to further restrictions: the *interest charge exception*[49] and the *pledge rule*.[50] The pledge rule provided that if an installment obligation is pledged to secure a loan or other indebtedness, the receipt of the proceeds from the loan or other indebtedness is treated as payment on the installment obligation.[51]

In 1988 when Congress passed the Omnibus Budget Reconciliation Act of 1987 it included Code § 453A(b)(3), which exempted farm property from both the interest charge exception and the pledge rule. The exemption extends to "any property used or produced in the trade or business of *farming*, within the meaning of Code § 2032(A)(e)(4) or (5)."[52] The definition of farm includes "stock, dairy, poultry, fruit, furbearing animal, as well as truck farms, plantations, ranches, nurseries, ranges, greenhouses, and other similar structures used primarily for the raising of agricultural or horticultural commodities, orchards, and woodlands."[53]

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45. *Id*. (emphasis added). The regulations state, that "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." *Id*.

46. Griffith v. Comm'r, 73 T.C. 933, 942-43 (1980).

47. Installment Sales Revision Act of 1980, Pub. L. No. 96-471 .

48. Technical and Miscellaneous Review Act of 1988, Pub. L. No. 100-647.

49. I.R.C. § 453A(c) (2012) (emphasis added).

50. I.R.C. § 453A(d) (emphasis added).

51. *See* I.R.C. §453A(d).

52. I.R.C. § 453A(b)(3). This provision cross references the definition of "farming" as defined in 26 U.S.C. §2032(A)(e)(4) or (5). *Id*.

53. I.R.C. § 453A(b)(4).

The definition of farming purposes in § 2032(A)(e)(5) has three subsections: A, B, and C.[54] These subsections cover the range of farming-related activities conducted on agricultural land. Subsection A defines farming purposes as "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."[55] Subsection B defines "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."[56] Finally, subsection C defines the "planting, cultivating, caring for, cutting, and preparation (other than milling) of trees for market."[57]

The express exception to the pledge rule is what allows monetized installment sales reporting to be available for property used in the trade or business of farming.[58] The availability of this pledge of cash or an irrevocable standby letter of credit to provide security for the future installment obligation is the conduit that permits the seller to secure a current loan without taking constructive or actual possession of the buyer's proceeds.

V. NOTHING NEW FOR THE INTERNAL REVENUE SERVICE

In a 2012 IRS Memorandum, the IRS discussed the application of judicial doctrines to the monetization of installment sales transactions.[59] Although the IRS Memorandum stated that it should not be cited for authority,[60] the analysis and content provide an in-depth look at how two judicial doctrines, the Substance Over Form Doctrine[61] and the Step Transaction Doctrine,[62] were dismissed within the context of a monetized installment sale transaction.

In the Memorandum, with the IRS National Tax Office concurring, the Associate Area Counsel (Large Business & International) concluded that:

54. I.R.C. § 2032(A)(e)(5) (2012).

55. I.R.C. § 2032(A)(e)(5)(A).

56. I.R.C. § 2032(A)(e)(5)(B).

57. I.R.C. § 2032(A)(e)(5)(C).

58. *See* I.R.C. § 453(A)(b)(3)(B) (providing an express exception for property used in the trade or business of farming, as defined in I.R.C. § 2032(A)(e)(4)(5)).

59. I.R.S. G.C.M. 20123401F (Aug. 24, 2012).

60. *See id*. (stating, "[t]his advice may not be used or cited as precedent").

61. *See id*. at 2 (defining first issue as "[w]hether the Service should assert the substance over form doctrine to disregard the form of Taxpayer's Transaction and disallow the taxpayer's deferral of gain recognition on its sale of Asset").

62. *Id*.

> [T]he steps in the Transaction accomplished legitimate business purposes and the independent economic significance. Taxpayer needed to sell its Asset and structured the sale in a way that minimized its taxes. Taxpayer did not create transactions with no substance merely to obtain tax benefits. Substantively, the steps of the Transaction matched their form: an installment sale coupled with a monetization loan. The Transaction allowed Taxpayer to take advantage of tax deferral on the Asset sale, which is a permitted result under I.R.C. §§ 453 & 453A.[63]

Because the IRS utilizes the Substance Over Form doctrine and Step Transaction doctrine to disallow a desired tax outcome, both doctrines need to be considered in every monetized installment sale transaction to ensure legitimate economic significance at each step of the transaction.

A. Substance Over Form Doctrine

In *Gregory v. Helvering*,[64] the United States Supreme Court held that when a transaction has no substantial business purpose other than the avoidance or reduction of tax, the tax law will not respect the transaction.[65] Simply put, the IRS and the courts contend the tax results of a transaction are best determined by reviewing the underlying substance of the transaction rather than the formal steps or documentation of the transaction.[66] Thus, a critical and factual analysis is required to determine if the Substance Over Form doctrine converts the transaction from the documented steps into what the IRS determines substantively occurred.

The United States Court of Appeals for the Second Circuit in *Newman v. Commissioner*[67] set out four relevant criteria in applying the Substance Over Form doctrine. First, there must be an existence of a legitimate non-tax business purpose. Second, a determination of whether the transaction has changed the economic interests of the parties. Third, a determination of whether the parties dealt with each other at arm's length. Lastly, fourth, a determination of whether the parties disregarded their own form.[68]

When the Substance Over Form doctrine applies, the IRS will recast the transaction according to the underlying substance of the

63. *Id*. at 11.
64. 293 U.S. 465 (1935).
65. Gregory v. Helvering, 293 U.S. 465, 470 (1935).
66. *Id*.
67. 902 F.2d 159 (2d Cir. 1990).
68. Newman v. Comm'r, 902 F.2d 159, 163-64 (2d Cir. 1990) (citing Frank Lyon v. United States, 435 U.S. 561 (1978)).

transaction and basically ignore, and not be bound by, the mere form of the transaction. Regrettably, taxpayers are not given the same deference. Taxpayers are typically bound by their chosen legal form of transaction.[69] In practice, the Substance Over Form doctrine has been used as a sword by the IRS, but it is unavailable to be used as a shield by the taxpayer.[70]

It is essential in drafting and structuring monetized installment sales transactions that each and every one of the steps have a legitimate non-tax business purpose that changes the economic interests of the parties.[71] Further, the parties to the monetized installment sale transaction should all deal at arm's length to guard against IRS claims that the transaction should be recast because the Substance Over Form doctrine applies and the IRS should not be bound by the written documentation of the transaction.

B. Step Transaction Doctrine

The *Penrod v. Commissioner*[72] court defined the step transaction doctrine as a situation in which one "treats a series of formally separate steps as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[73] In effect, the IRS will disregard the taxpayer's path and the transaction's unnecessary steps.

The courts have developed three methods to identify when the step transaction doctrine should apply: End Result Test, Interdependence Test, and Binding Commitment Test. The End Result Test evaluates whether it is evident that each of a series of steps is undertaken for the purpose of achieving the ultimate result.[74] The Interdependence Test requires that each step be so interdependent that the completion of an individual step would be meaningless without the completion of the remaining steps. Alternatively stated, the step transaction doctrine applies if "the steps are so interdependent that the legal relations created by one transaction would have been fruit-

69. *See, e.g.*, Comm'r v. Danielson, 378 F.2d 771, 777 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967); Matter of Insilco Corp., 53 F.3d 95, 98-100 (5th Cir. 1995).

70. *See Danielson*, 378 F.2d at 777; *see also Insilco Corp*., 53 F.3d at 98-100.

71. *See* Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298, 388 (D.D.C. 2001), *rev'd,* 314 F.3d 625 (D.C. Cir. 2003) (holding that each sale or purchase must have some purpose beyond simply tax avoidance, and must have at least a reasonable possibility of profits or some form of economic substance); *see also* ACM P'ship v. Comm'r, 157 F.3d 2331 (3d Cir. 1998) (disallowing an installment sale because the transaction lacked economic substance when it was solely entered into for purposes of generating a loss).

72. 88 T.C. 1415 (1987).

73. Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

74. King Enters. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969)

less without a completion of the series."[75] The Binding Commitment Test requires an evaluation of whether, at the time the first step is entered into, there is a legally binding commitment to complete the remaining steps.[76]

Two additional factors have developed from case law to determine whether to invoke the step transaction doctrine, the intent of the taxpayer and the temporal proximity of the separate steps. Excluding cases involving a legally binding agreement, if each of a series of steps has independent economic significance, the transactions should not be stepped together.[77]

VI. THE DOCUMENTS FOR A MONETIZED INSTALLMENT SALE TRANSACTIONS

The starting point for drafting a monetized installment sale transaction is the installment sales contract. For the installment sale of real estate, the contract will contain standard real estate provisions similar to the traditional land contract. However, for the monetization to be successfully executed, the installment contract must contain language permitting the assignment of the buyer's performance and obligations to a third-party obligor.

The installment sales contract should clearly state that the transaction is an installment sale between the buyer and seller, providing that the buyer will make periodic payments that are intended to qualify for the installment sales treatment under Code § 453 for the benefit of the seller. A savings clause stating that the obligor and the seller may make reasonable modifications or revisions as necessary to confirm the seller's intention to obtain § 453 income tax treatment is an appropriate addition to the installment sales contract. The savings clause will be beneficial if future tax law changes cast doubt on an element in the transaction.

The transition of the buyer's obligations to the third-party obligor is accomplished by an assignment. In addition to standard assignment provisions, the assignment should include the direction that the closing agent will deliver the net purchase price for the future installment payments to the third-party obligor. The obligor will, in turn, agree to make the installment payments and fulfill the buyer's obligations as set forth in the Installment Sales Contract.

At the initial closing, when the assignment is delivered, and the buyer delivers the full installment purchase amount to the third-party obligor, the deed or bill of sale is delivered to the buyer. Typical real

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75. Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980).
76. Comm'r v. Gordon, 391 U.S. 83, 96 (1968).
77. Reef Corp. v. Comm'r, 368 F.2d 125, 133 (5th Cir. 1966).

estate prorations, title insurance, title costs, and other recording fees are all reflected on the initial closing statement. The closing statement should clearly reflect the payment to the obligor and the closing statement status as merely preliminary due to the transaction's structure as an installment sale.

At the initial closing, the seller, purchaser, and obligor jointly execute an "Assignment and Assumption of Nonnegotiable Promissory Note," which confirms the responsibilities of the substitute obligor. By reference, this document incorporates the initial installment sales contract and the nonnegotiable promissory note, which set forth the installment payment schedule. Sometimes the nonnegotiable promissory note is also referred to by attorneys as an installment note. Regardless of terminology, it is essential that the installment note be nonnegotiable. If the installment note is negotiable, the tax deferral under Code § 453 fails because the seller is treated as receiving cash, as a negotiable promissory note can by its very terms be negotiated for cash.[78]

The obligor must be an actual third party and not a mere agent of the seller.[79] The cases make it clear that the seller cannot directly or indirectly have control over the proceeds from the sale.[80] However, the mere substitution or change of one third-party obligor for a new or different obligor in the future will not disqualify installment sale tax treatment.[81]

For a monetized installment sale, once the initial closing is complete and the funds are in the custody of the obligor, the loan phase of the transaction is the distinct next step. The loan portion is primarily comprised of the letter of credit and loan agreement.

A bank or financial institution[82] issues an irrevocable standby letter of credit that can only be drawn upon in the event of default.[83] This standby letter of credit is the collateral that makes the loan relatively risk-free. It is backed by the buyer's cash that is deposited with the obligor.

78. *See* Champy v. Comm'r, 68 T.C.M (CCH) 242 (T.C. 1994) (disallowing installment method when promissory note given by the buyer in the transaction was payable on demand and not an installment notice).

79. *See* Scherbart v. Comm'r, 453 F.3d 987 (8th Cir. 2006) (confirming that the disposition of farm commodity by a co-op would qualify for installment sale reporting because the co-op sold the commodities as an agent for the farmer).

80. Rushing v. Comm'r, 441 F.2d 593, 598 (5th Cir. 1971).

81. *See generally* Wynne v. Comm'r, 47 B.T.A. 731 (1942) (stating that the substitution of a new obligor in the place of the former obligor did not require immediate recognition of the deferred gain).

82. *See* 25 C.F.R. § 15a.453-1(b)(3)(iii) (2018) (requiring a bank or financial institution as issuer).

83. *See* 25 C.F.R. § 15a.453-1(b)(3)(iii) (stating that a letter of credit cannot be drawn upon in the absence of default).

The standby letter of credit has been one of the problem areas in monetizing the installment sale. The IRS acknowledges that a standby letter of credit can be used as the collateral to successfully monetize an installment sale.[84] Furthermore, Code § 453(f)(3) provides the statutory authority for the use of a standby letter of credit as security in a monetized deferred payment transaction without it being reclassified as a payment received on the installment obligation.[85] However, the limitations and conditions contained in the standby letter of credit should match the requirements enumerated in IRS regulations.[86]

An experienced and knowledgeable obligor will have relationships with lenders. These relationships put the obligor in the best position to negotiate and secure the loan for the seller. This is the point when the obligor's contacts and relationships should assist the seller in securing favorable loan terms. Frankly, this is most likely where a good obligor adds significant value to the overall transaction. Without the obligor's contacts, finding a lender that has the knowledge to appreciate that the transaction is relatively risk-free and should carry a low interest rate is difficult. Many lenders do not fully understand monetized installment sale transactions, thus they are not willing to commit to long-term loans with rates that are often at or below prime.

Once the third-party obligor provides the irrevocable standby letter of credit and the nonnegotiable promissory note to the seller, the seller can proceed with obtaining the loan agreement with a lender. The lender will require a pledge agreement in which the borrower/seller (i.e. pledgor) is pledging to lender (pledgee) a security interest in certain assets of the pledgor. Namely, the pledgor or borrower is granting a security interest in its collateral, which is the standby irrevocable letter of credit. When working with a knowledgeable third-party obligor the pledgor can secure the loan agreement and negotiate the loan terms for the borrower/seller.

When the loan portion of the transaction is closed the seller will, in effect, have received approximately ninety-five percent of the sale proceeds in the form of a loan. The five percent is an estimate of the fees and costs for the obligor and lender fees that are paid at the time of the installment sale's initial closing. The periodic interest pay-

84. I.R.S. Tech. Adv. Mem. 200105061 (2000). The IRS approved installment sale where buyer's installment obligation was secured by standby letter of credit.

85. I.R.C. § 453(f)(3).

86. 25 C.F.R. §15a.453-1(b)(3)(iii). These regulations state that "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." The regulations require all standby letters of credit to be nonnegotiable and non-transferable except together with the evidence of indebtedness which it secures, and also to be issued by a bank or other financial institution.

ments are received by the seller from the obligor who is paying interest on the buyer's proceeds held and invested by the obligor. In turn, the seller/borrower will make periodic interest payments to the lender from the proceeds received by the seller/borrower from the obligor.

In the final step of the transaction it is recommended to have an attorney knowledgeable about Code § 453 provide the seller with an attorney's tax opinion. This opinion provides a basis to avoid potential penalties for underpayment of income tax if the transaction is not structured properly. In addition, tax opinions are typically issued only by law firms that are conversant with the tax matters they are reviewing. As such, the attorney's tax opinion does not guarantee success, but it does provide additional assurance that the steps and documentation for the tax deferral under § 453 have been satisfied.

The monetization of the installment sale contract provides sellers of farm realty and farm commodities with the advantages of immediate receipt of cash and deferral of the income taxes for decades. It also permits the seller to avoid the financial risks associated with long-term contractual relationships with buyers that are inherent in traditional installment sale transactions. As sellers of farmland and farm commodities are looking for methods to liquidate these types of assets without immediate income taxation, the monetized installment sale transaction will become a standard in the agricultural community.