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A Conversation with a Tax Advisor about Tax Doctrines: Step Transactions, Substance over Form, Economic Substance, Sham Transactions, and Assignment of Income, and Whether and How They Pertain to Monetized Installment Sale ("M453SM") Transactions

Note: This document is a composite of various conversations and is not a *verbatim* transcript of one particular conversation. It is, however, representative of a number of such conversations.—Stan Crow

The Step-transaction Doctrine

Tax Advisor: I'm concerned that an M453SM transaction might be regarded as a "step transaction" and that the loan proceeds might therefore be treated as cash payment on the installment contract.

Stan Crow: You are referring to the proceeds of a monetization loan made to the seller by the lender which is introduced to the seller by S.Crow Collateral Corp.?

Tax Advisor: Yes.

Stan Crow: I take it that you are referring to the doctrine which states, in the words of the IRS Office of Chief Counsel, in Memorandum No. 20123401F, August 24, 2012, the following: "The step transaction doctrine applies in cases where a taxpayer seeks to go from point A to point D and does so by stopping at intermediary points B and C. The purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts may disregard the taxpayer's path and the unnecessary steps."

Tax Advisor: That's right.

Stan Crow: In your concern about the step-transaction doctrine, are you thinking of the "binding commitment" test, the "interdependence" test, or the "end result" test?

Tax Advisor: Well, maybe all three.

Stan Crow: We can agree, I assume, that under the "binding commitment" test a series of transactions will be stepped together only if at the time that the first step is commenced there is a binding legal commitment to undertake the subsequent step(s).

Tax Advisor: Yes.

Stan Crow: Did you realize that a seller may sell with an $M453_{SM}$ contract and that in no way commits the seller to accept a loan from the lender?

Tax Advisor: No, I didn't know that.

Stan Crow: And did you know that a seller may apply for a loan from the lender without any commitment whatever to enter into an $M453_{SM}$ contract?

Tax Advisor: No, I didn't know that, either.

Stan Crow: And did you know that a seller may enter into an $M453_{SM}$ contract either before or after the loan transaction, or may enter into a loan transaction either before or after an $M453_{SM}$ contract is signed?

Tax Advisor: No.

Stan Crow: And did you know that even after an $M453_{SM}$ contract has completely closed, the seller is not required to proceed with the monetization loan?

Tax Advisor: No.

Stan Crow: Under those facts, the "binding commitment" test would not apply, would it?

Tax Advisor: I suppose not. Maybe the "interdependence" test or the "end result" test would still apply?

Stan Crow: Well, let's see. Do you agree with the following, as found in the Office of Chief Counsel Memorandum cited above, at page 8: "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. *Reef Corporation v. Commissioner*, 368 F.2d 125 (5th Cir. 1966)."

Tax Advisor: I guess I have no choice but to agree with that.

Stan Crow: So, let's take the interdependence test first. We can agree, I expect, that under the interdependence test, a series of transactions will be stepped together if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. Right?

Tax Advisor: Yes.

Stan Crow: By now, though, you see the difficulty, don't you, with trying to apply that test to an M453SM transaction and the separate loan from a lender to the seller? That difficulty arises, because in fact the two transactions are *independent*, not *interdependent*. Each one can stand alone, and in fact does stand alone.

Tax Advisor: Okay, I see that, but what about the "end result" test?

Stan Crow: Let's see whether we agree on what the "end result" test is. Tell me whether you agree with this statement of it: Under the end result test, a series of seemingly separate transactions will be stepped together whenever the evidence shows that the parties' intent at the outset was to achieve one particular result, and that the seemingly separate steps were all entered into as a means of achieving that one result. This test applies when the parties could have achieved the same result in a more direct manner with fewer transactions.

Tax Advisor: I agree; that's a correct statement of the test.

Stan Crow: So, let me ask you this: Whether it's a cash sale or an installment sale, how many transactions does it take to sell an asset?

Tax Advisor: One.

Stan Crow: That's right, so selling on an installment contract involves no extra (that is, unnecessary) transactions. And, do you agree that any seller has the complete right to choose to sell for cash or to sell on an installment contract?

Tax Advisor: Yes, both the courts and the IRS have made that clear.

Stan Crow: And that's true even though the seller must pay the capital-gains tax immediately if it's a cash sale but may defer paying the tax if it's an installment sale? The fact that there's a tax benefit if it's an installment sale doesn't diminish the seller's right to choose an installment sale?

Tax Advisor: That's right, but in the case of an M453SM transaction the seller may also choose to borrow money and therefore have cash—almost as much cash as the seller would have received in a cash sale. So there is an unnecessary transaction, and it could be stepped together with the M453SM installment sale.

Stan Crow: How many transactions does it take to complete a loan?

Tax Advisor: One.

Stan Crow: So if someone wants to sell an asset with an installment contract and also wants to take out a loan, there will be two transactions—and only two, with no unnecessary ones.

Tax Advisor: But the loan is itself an unnecessary transaction, because if instead the seller sells for cash, the seller doesn't need to take out a loan.

Stan Crow: How is it that you know that a cash seller doesn't need or want to borrow other money? If a seller chooses a cash sale, is there any reason why the seller cannot also choose to borrow money and have even more cash?

Tax Advisor: None that I know of.

Stan Crow: By your logic, if a cash seller takes out a loan, I suppose you would say that the cash seller who borrows money has more cash, so that loan transaction can be stepped together with the cash sale, and the loan proceeds can be treated as additional proceeds of the cash sale, the same as if the selling price on the cash sale had been increased by the amount of the loan proceeds.

Tax Advisor: Why would the IRS want to step together a cash sale and a loan?

Stan Crow: To collect tax on higher purported capital gains, and because the IRS might argue that the seller could have sold for a higher price but chose instead to sell low and then borrow money, to reduce the tax cost but still have the desired amount of cash.

Tax Advisor: That wouldn't be a step-transaction situation, though, because the buyer in a cash sale would have no connection with whatever loan the seller might decide to take out. The loan would not be an extra (that is, unnecessary) transaction; it would be nothing more nor less than a completely separate decision to borrow money.

Stan Crow: Exactly, I agree you—and that shows why it is that the "end result" test cannot be used to step together an M453$_{SM}$ installment sale and a separate loan which the seller may decide to take out. Just as in the situation of a cash seller who borrows money, the buyer in an M453$_{SM}$ transaction has no connection with whatever loan the seller might decide to take out, and whether or not the seller takes out a loan is a completely separate decision by the seller.

Besides, there's a more fundamental reason why the step-transaction doctrine cannot be applied to collapse together the M453$_{SM}$ installment sale and the separate loan.

Tax Advisor: What's that?

Stan Crow: Congress has already examined the question of when loan proceeds can be treated as proceeds of an installment sale, and Congress amended the statute in 1980 to provide the governing rule for monetization loans. In Section 453A(d)(4), Congress said that loan proceeds can be treated as installment-sale proceeds to the extent that payment of principal or interest on a loan other than an agricultural loan is "directly secured . . . by any interest in such installment obligation". That means that if the lender on a non-agricultural loan is given an interest in the installment contract as security for the loan, the loan proceeds can be treated as sale proceeds to the extent that the lender takes an interest in the installment debt to satisfy all or part of the amount owed on the loan. The IRS has no authority to use the step-transaction doctrine to ignore those statutory limitations. Anyway, none of that happens for the lender on the loan to an M453SM seller; in fact, the M453SM installment contract explicitly prohibits any pledge of the installment contract or any assignment of any interest in it.

Tax Advisor: Besides the statutory instances of a pledge or assignment of the installment contract, why can't the IRS provide for other grounds to apply the step-transaction doctrine to treat monetization loan proceeds as installment-sale proceeds?

Stan Crow: It's likely that the Treasury could, by regulation, provide for *additional* tests that would have to be met for loan proceeds to be treated as sale proceeds, but the Treasury cannot provide *alternative* grounds to those set forth in the statute, because that would mean that the Treasury (the IRS) could override what Congress did. That would amount to allowing the IRS to say that it doesn't have to show that the statutory tests were met. The Treasury could say, by regulation, that the hurdle for treating loan proceeds as sale proceeds must be higher, but the Treasury cannot ignore statutory law to make the hurdle is a different one from the one that Congress said it is. Besides, doing so would clearly violate Congress' intent, in its adopting installment reporting in 1913 and retaining it ever since; nearly everyone has a loan of some kind, and if any loan could be stepped together with any installment sale, virtually no one would ever be able to obtain the tax benefit (installment reporting) for which Congress has provided for more than 100 years.

Tax Advisor: Could the IRS say that the direct-deposit, direct-pay arrangement through the long-term escrows amounts to a loan that is "directly secured . . . by any interest in such installment obligation"?

Stan Crow: The IRS could not say that, without depriving the statutory "directly secured" phrase of any meaning. To say that a loan is "directly secured" is to say that some lien on some collateral is present as security for the loan. An arrangement which causes money to go automatically from an account owned by the borrower to an account owned by the lender is no more secured—has no more collateral for it—than is an arrangement by which the borrower manually writes a check every month; the automatic nature of the deposit and withdrawal adds no security to which the lender can turn if the money is not in fact there.

Anyway, for purposes of section 453A(d), indebtedness is secured by an installment obligation only if the creditor with respect to the indebtedness has a "security interest" in the installment obligation within the meaning of section 1-201(37) of the *Uniform Commercial Code*, according to *ABA Committee Advises Treasury On Formulating Forthcoming Nondealer Regs*, 91 TNT 115-21, Section V.A.1. (Suggesting this formulation).

Anyway again, the IRS has already cleared away the step-transaction doctrine from application in these circumstances.

Tax Advisor: How is that?

Substance Over Form, Economic Substance and Step Transactions

Stan Crow: In that Office of Chief Counsel Memorandum No. 20123401F mentioned above, the IRS dealt with a much more complicated arrangement than is the case for an $M453_{SM}$ installment sale and a separate monetization loan from a lender, and the IRS examined the matter on both economic-substance and step-transaction grounds, starting with economic substance first.[1] Beginning at page 9, the Memorandum states:

> The Transaction meets the statutory and regulatory requirements of I.R.C. § 453. Because Asset meets the definition of farm property under I.R.C. § 2032A(e)(4), Taxpayer can pledge the Purchase Notes and obtain cash through a separate loan under I.R.C. § 453A(b)(3)(B) without the proceeds being treated as a payment for installment sale purposes. The Code and the regulations also specifically allow a standby letter of credit to secure an installment sale obligation. The Letters of Credit issued in the Transaction meet the definition of a standby letter of credit under Temp. Treas. Reg. § 15a.453-1(b)(3)(iii) because they are non-negotiable, non-transferable, and can be drawn upon only in the event of default. Example (7) of the regulations clearly provides that a standby letter of credit can be secured by cash collateral. As in Example (7), the Deposits secure the Letters of Credit, not the Purchase Notes. The Taxpayer cannot look directly to the Deposits for payment; only the LOC Banks and Buyer have a direct interest in the Deposits. At the time of the sale, Taxpayer received the proceeds of the Monetization Loans secured by the Purchase Notes and Letters of Credit; Taxpayer did not receive funds from the Deposits securing the Purchase Notes.
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> Application of the Substance Over Form Doctrine
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> In form, Taxpayer's Transaction comprised: (1) an installment sale, pursuant to which Taxpayer received the Purchase Notes backed by the Letters of Credit, and (2) a loan monetizing the Purchase Notes. The question presented is whether the substance of the Transaction was essentially a cash sale—shortly after the Asset sale Taxpayer obtained U% of the sales price in cash and an additional X% of the face value of the Purchase Notes through loan proceeds, all while deferring most of the gain recognition and tax on the transaction for R years.

[1] The Memorandum speaks of ways in which the transaction had economic substance but does so under the purview of "substance over form" rather than under the purview of the economic-substance doctrine as such.

We conclude that the substance over form doctrine does not apply in this case. Using the Newman v. Commissioner criteria discussed above, the substance of the Transaction is consistent with its form. First, each step in the transaction had a specific business purpose. The sale of the Asset was a real transaction carried out to raise cash for Taxpayer. The Letters of Credit, by definition, provided economic security for Taxpayer in the event of Buyer's default. The Deposits served as the collateral. Taxpayer negotiated the Monetization Loans with a financial institution separate from the financial institutions that issued the Letters of Credit and held the Deposits.

Second, the economic interests of the parties did in fact change. After the Transaction, Taxpayer no longer owned the K Amount of Asset, Taxpayer held the Purchase Notes backed by the Letters of Credit, and Taxpayer's SPEs were obligors under the Monetization Loans with Lender in the total amount of $B. The economic interests of Buyer and Lender changed as well. Buyer deposited $D with the LOC Banks to secure the standby letters of credit and pay associated fees and became the new owner of the Asset. Lender parted with $B in exchange for the Monetization Loans, secured by the Purchase Notes and Letters of Credit.

Third, there is no indication that the terms of the Transaction are not arm's length. The terms of the Purchase Notes appear to be regular, commercial terms, with market-based interest rates. While the interest rate to be paid on the Monetization Loans is unusual, the loan agreement shows it to be structured as a commercial loan.

Fourth, all parties involved have treated the steps of the Transaction as a separate installment sale and monetization loan.

The Taxpayer reduced its risk exposure on the Monetization Loans by carrying out the monetization of the Purchase Notes through its two bankruptcy-remote LLCs and by making the Monetization Loans nonrecourse. Nevertheless, the taxpayer is still at risk. The Taxpayer only received X% of the face value of the Purchase Notes in loan proceeds and is therefore still at risk on the remaining Y% should one or more LOC banks fail. Taxpayer tried to limit this risk by spreading the LOCs among several banks and requiring LOC replacement if a bank's credit rating went below a certain level. This limited the risk, but did not eliminate it, given the high concentration of Z banks acting as counterparties. In addition, to recast the transaction as a cash sale would be to assume Taxpayer had already forfeited that remaining Y%, which it clearly has not done.

Stan Crow: Because the Memorandum states that the taxpayer in that matter was still at risk, I should mention that in the case of an $M453_{SM}$ seller who borrows from the lender introduced to the seller by S.Crow Collateral Corp., the $M453_{SM}$ seller remains fully indebted and liable on the entire amount of the loan in the event of any default by the seller. The $M453_{SM}$ seller's litigation risk because of collection proceedings brought against the seller by the lender is limited to an amount of money that is equal to the amount that is paid by S.Crow Collateral Corp. on the installment contract, so the $M453_{SM}$ seller cannot be forced to pay the lender more than S.Crow Collateral Corp. pays to the seller, *if there is no default by the seller*. Anyway, up to the amount which S.Crow Collateral Corp. pays to the seller, the seller's liability on the loan is a *general, not limited*, liability.

Then, at p. 10, the Memorandum continues:

> Application of the Step Transaction Doctrine
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> Because the step transaction doctrine is an extension of the substance over form doctrine, the step transaction doctrine also does not apply to this case. As noted above, the step transaction doctrine applies in cases where a taxpayer seeks to go from point A to point D and does so by stopping at intermediary points B and C, steps which give the taxpayer a tax benefit. The question is whether the interrelated steps between Taxpayer signing the sales contract and Lender wiring the Monetization Loan proceeds directly into Taxpayer's accounts should be collapsed.
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> "Step A" is the transfer of the Asset to Buyer while "Step D" is the transfer of the Monetization Loan proceeds from Lender to Taxpayer (through Taxpayer's SPEs). Collapsing the Transaction and going straight from Step A to Step D does not make sense. Taxpayer is selling the Asset to Buyer, while the loan proceeds are coming from Lender, which is unrelated to both Taxpayer and Buyer. [The same is true for a loan to an $M453_{SM}$ seller: the lender is unrelated to the seller and to the buyer.] In fact, to go from Step A to Step D and to treat the Transaction as a cash sale would require additional steps, which the Internal Revenue Service is prohibited from creating. See Grove v. Commissioner, 490 F.2d at 247.
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> Furthermore, the steps that did occur between "Step A" and "Step D" were not unnecessary or meaningless steps. The Deposits made by Buyer were necessary to back the Letters of Credit. The Letters of Credit were necessary to secure the Purchase Notes in the event of Buyer's default. The transfer of the Purchase Notes to the SPEs was necessary to protect Taxpayer in the event of Buyer's default. The pledging of the Purchase Notes and Letters of Credit was necessary in order for Taxpayer to receive the amount of loan proceeds

> it needed to carry out its Plan, pay off its existing corporate debt, and complete Event HH in order to accomplish Purpose.
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> Each of the steps has independent economic significance; therefore, the step transaction does not apply under either the end result test or the interdependence test. The binding commitment test would not be applicable in this case because there is no contractual obligation to complete all of the Transaction steps.
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> In summary, the judicial doctrines of substance over form and step transaction do not apply in this case. The steps in the Transaction accomplished legitimate business purposes and had 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 and 453A.

Stan Crow: After that, do you see any remaining concern with M453$_{SM}$ and the separate loan, under the step-transaction doctrine or economic-substance doctrine?

Tax Advisor: I can't really say that I do.

Stan Crow: Anyway, now that the economic-substance doctrine has been codified in Section 7701(o), the IRS has issued a "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties", by the IRS Commissioner for the Large Business and International Division, LB&I Control No: LB&I-4-0711-015, July 15, 2011. That document states:

> In addition, this LB&I Directive provides that, until further guidance is issued, the penalties provided in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

The Guidance document went on to list 18 factors which are contrary indications for application of the economic-substance doctrine, and 17 factors which are favorable indications for application of the doctrine. This has been published for all to see, and I think it is no longer competent professional practice for a tax advisor to speak either way about economic substance without doing a careful examination of the circumstances in light of those 35 factors.

Tax Advisor: What are the 18 factors which are contrary indications for application of the economic-substance doctrine?

Stan Crow: The Guidance document lists the following bulleted items, with my comment after each:

- Transaction is not promoted/developed/administered by tax department or outside advisors

M453SM transactions are developed and offered by S.Crow Collateral Corp. as an arm's length buyer as a principal in the deal for its own account, not as an advisor. S.Crow Collateral Corp. is not an advisor to any seller. If there could be any doubt about that, it would be dispelled by the fact that S.Crow Collateral Corp. re-sells the asset which it purchases in an M453SM transaction, and S.Crow Collateral Corp. retains the *entire proceeds* of the resale. Have you ever heard of an *advisor* who is compensated that way?

- Transaction is not highly structured

The M453SM transaction is typically documented in just three instruments: the installment contract, long-term escrow instructions for the processing of the monthly installment-interest payments and final principal payment, and closing instructions for the execution of the documents and disbursement of funds.

The lender's separate loan transaction instruments typically consist of a loan agreement, a promissory note, long-term escrow instructions for the processing of the monthly loan-interest payments and final loan-principal payment, and loan-closing instructions for the execution of the documents and disbursement of funds. Sometimes there may be a loan commitment as well.

- Transaction contains no unnecessary steps

The M453SM transaction is just one step, and the separate loan, if it occurs, is just one step.

- Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives

As the Office of Chief Counsel Memorandum No. 20123401F stated, "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 and 453A." What more need be said?

- Transaction is at arm's length with unrelated third parties

S.Crow Collateral Corp., the seller and the lender are all unrelated to each other, and none has any ownership interest or management participation in any of the others.

- Transaction creates a meaningful economic change on a present value basis (pre-tax)

An installment seller in an M453$_{SM}$ transaction actually disposes of a capital asset and the risks and benefits that go with it.

- Taxpayer's potential for gain or loss is not artificially limited

As is true of a cash sale, an installment seller in an M453$_{SM}$ transaction realizes whatever gain or loss results from the sale, as negotiated by the parties.

- Transaction does not accelerate a loss or duplicate a deduction

A seller who has a loss is unlikely to use an M453$_{SM}$ transaction anyway, and an M453$_{SM}$ transaction does not generate any deductions that a cash sale wouldn't.

- Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

The M453$_{SM}$ transaction doesn't generate any deductions that a cash sale wouldn't.

The separate loan transaction, if it occurs, can be expected to generate interest-expense deductions for the seller's loan-interest payments, but the deductions will be for interest expenses actually incurred and actually paid.

- Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction

As the Office of Chief Counsel Memorandum No. 20123401F pointed out, installment sales under Section 453 are a special case:

> The Code and the regulations also specifically allow a standby letter of credit to secure an installment sale obligation. The Letters of Credit issued in the Transaction meet the definition of a standby letter of credit under Temp. Treas. Reg. § 15a.453-1(b)(3)(iii) because they are non-negotiable, non-transferable, and can be drawn upon only in the event of default. Example (7) of the regulations clearly provides that a standby letter of credit can be secured by cash collateral.

Therefore, the existence of a limitation on an installment seller's risk of not being paid is not significant with regard to the economic-substance doctrine. More fundamentally, however, is the fact that nothing in an M453$_{SM}$ transaction guarantees to the seller that S.Crow Collateral Corp. will in fact pay its installment debt to the seller; the seller retains that risk, and the seller retains the risk of having to institute collection proceedings if S.Crow Collateral Corp. doesn't pay.

It's true that an M453$_{SM}$ seller may choose to obtain a loan with a provision which precludes the lender from compelling the seller to repay the loan to the extent that S.Crow Collateral Corp. doesn't pay on the installment contract. Even so, an M453$_{SM}$ seller with such a loan remains *fully indebted* on the loan and can be compelled to pay the full amount regardless of what S.Crow Collateral Corp. does, if the seller defaults in any way under the loan agreement other than because of nonpayment by S.Crow Collateral Corp.

Further, the limitation on the seller's risk of having to pay money on the loan that has not been paid by S.Crow Collateral Corp. on the installment contract has what may be a surprising, but nonetheless intentional, effect: it *reduces* the seller's risk of not being paid on the installment contract. The reputational cost for S.Crow Collateral Corp. which would exist in the event of any failure by S.Crow Collateral Corp. to pay on an installment contract as agreed is much enhanced by the knowledge that a failure to pay even one M453$_{SM}$ seller could result in loss to a lender with whom S.Crow Collateral Corp. has a highly valued relationship. The M453$_{SM}$ seller knows that, and therefore the M453$_{SM}$ seller knows that the risk that S.Crow Collateral Corp. might not pay as agreed on the M453$_{SM}$ contract is much lower than it would otherwise be.

Therefore, the limitation in the loan agreement on the lender's ability to compel the seller to pay is a substantive mechanism to reduce the risk that S.Crow Collateral Corp. might not pay as agreed on the M453$_{SM}$ installment contract. In turn, that reduces the seller's risk of dispute with the lender. It is a way in which the M453$_{SM}$ seller can *maximize the likelihood that S.Crow Collateral Corp. will pay as agreed*, by bringing to bear the leverage of a relationship that is very important to S.Crow Collateral Corp.

Anyway, the risk that the seller might not be paid on the installment contract is only one of the economic risks of the transaction. As is true of cash sales, sellers in M453$_{SM}$ transactions are always at risk of missing the market on the disposition of the asset, at risk of loss on the investment of sale proceeds, and at risk of loss under the representations and warranties accompanying the sale.

- Transaction does not involve a tax-indifferent counterparty that recognizes substantial income

Neither S.Crow Collateral Corp. nor the lender is tax-indifferent.

- Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

None of this occurs in an M453$_{SM}$ transaction.

- Transaction has credible business purpose apart from federal tax benefits

The M453$_{SM}$ seller wants to dispose of a capital asset which will actually change hands and for which the costs and benefits will change hands.

- Transaction has meaningful potential for profit apart from tax benefits

That is a given; if there were not a potential for meaningful profit, the seller would not be seeking tax deferral.

- Transaction has significant risk of loss

All of the risk of loss that pertains to a cash sale pertains to an installment sale, and more so. That includes risk of mis-pricing, and the risk of litigation or liability, or both, regarding representations and warranties, title defects, environmental contamination, and so on.

- Tax benefit is not artificially generated by the transaction

The tax benefit (tax deferral) is generated by the actual sale of a capital asset, just as is true for any installment sale.

- Transaction is not pre-packaged

Every M453$_{SM}$ transaction is negotiated, any loan transaction with the lender introduced to the seller by S.Crow Collateral Corp. is negotiated, and the texts of the transaction documents are negotiated. Nothing about this is an off-the-shelf deal.

- Transaction is not outside the taxpayer's ordinary business operations.

An installment sale is a commonplace method of sale of capital assets, and has been such for centuries. It's no more outside the norm for a particular seller than a cash sale would be, because nearly every taxpayer contemplates eventually selling whatever assets the seller owns.

Tax Advisor: What are the 17 factors which are favorable indications for application of the doctrine of economic substance?

Stan Crow: Essentially the reverse of the foregoing 18, they are as follows (and they don't require any comment by me):

- Transaction is promoted/developed/administered by tax department or outside advisors
- Transaction is highly structured
- Transaction includes unnecessary steps
- Transaction is not at arm's length with unrelated third parties

- Transaction creates no meaningful economic change on a present value basis (pre-tax)
- Taxpayer's potential for gain or loss is artificially limited
- Transaction accelerates a loss or duplicates a deduction
- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction involves a tax-indifferent counterparty that recognizes substantial income
- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has no credible business purpose apart from federal tax benefits
- Transaction has no meaningful potential for profit apart from tax benefits
- Transaction has no significant risk of loss
- Tax benefit is artificially generated by the transaction
- Transaction is pre-packaged
- Transaction is outside the taxpayer's ordinary business operations.

Effect of Immediate Resale; "Sham" Transactions

Tax Advisor: Okay, I get that. What about the fact that when S.Crow Collateral Corp. purchases a capital asset on an M453$_{SM}$ installment contract, S.Crow Collateral Corp. immediately re-sells the asset to someone else for cash, often to someone to whom the M453$_{SM}$ seller would have sold directly for cash, if the M453$_{SM}$ seller hadn't sold to S.Crow Collateral Corp.?

Stan Crow: So are you suggesting that the fact that S.Crow Collateral Corp. doesn't retain ownership for a period of time could mean that the installment sale isn't real?

Tax Advisor: Right. Maybe the installment sale is a sham transaction, if S.Crow Collateral Corp. immediately re-sells.

Stan Crow: Have you ever heard of even one instance in which the IRS or a court questioned the validity of an installment sale because the installment buyer other than a related party didn't keep the asset for some period of time?

Tax Advisor: No.

Stan Crow: Have you even heard of an instance in which the IRS or a court inquired to see how long an unrelated installment buyer retained the asset?

Tax Advisor: No.

Stan Crow: Why do you think that a short or no holding period by the installment buyer might mean that the installment sale isn't real?

Tax Advisor: If the installment buyer didn't want to retain the asset, I question whether it was a real purchase.

Stan Crow: So if the installment buyer's purpose is simply to make an immediate profit on resale of the asset, why is the installment buyer's pursuit of turnover profit any less viable than an installment buyer's pursuit of operating profit from use of the asset? Why is one kind of profit "real" and the other kind not?

Tax Advisor: I hadn't thought of it that way.

Stan Crow: Besides, S.Crow Collateral Corp. is a *dealer* in capital assets, which means, as it does for dealers of all kinds, that the dealer's whole line of business is re-selling assets as quickly as possible, not holding them for the purpose of operating profit. Dealers make their money from selling assets, not holding them.

Tax Advisor: But isn't it true that S.Crow Collateral Corp. doesn't generally go into title on real estate or other assets that it buys?

Stan Crow: Yes, that is true, but what significance is that? Accommodators for 1031 exchanges typically don't go into title, either, and yet the Treasury's 1031 Regulations treat a 1031 accommodator as the buyer of the relinquished property. Title, such as is reflected in a deed to real estate, is not a sale. Passage of title is the *result* of a sale and *evidence* of ownership, and the buyer has the right to take title or to arrange for title to bypass the buyer and go on to someone else. Title passes *however* the agreement of sale provides, to *whomever* the agreement of sale designates, and *whenever* the agreement of sale requires—at the same time as the sale, or later, even much later. Usually those decisions will have little or nothing to do with tax consequences. I think what you're talking about here, in your emphasis on what is "real", is the "sham transaction" doctrine.

Tax Advisor: I suppose I am.

Stan Crow: In regard to the sham-transaction doctrine, as for the others we've discussed, the IRS has clearly addressed the matter. In remarks on January 25, 2005, at the University of California Tax Institute, Donald L. Korb, chief counsel for the IRS, said the following:

> Naturally, before a court can determine whether a transaction lacks economic substance, the court must first determine whether the transaction itself did in fact actually occur. Thus, a court will not inquire into whether a transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a factual sham. This is a threshold question—whether the transaction is a so-called 'sham in fact.' In

> effect in these transactions—these sham transactions—the taxpayers claim deductions for transactions that have been created on paper but which never in fact took place.
>
> There are not as many of these types of cases today as we saw back in the late 1970's and early 1980's, during the heyday of the individual tax shelter industry. Needless to say, when a transaction never actually occurred, it is easy for a court to disallow the purported tax benefits on the fundamental ground that the transaction is not a real transaction.

Stan Crow: It would be impossible to compile a coherent rationale for saying that an $M453_{SM}$ installment sale transaction "never in fact took place." In an $M453_{SM}$ transaction, S.Crow Collateral Corp. undertakes, as a general obligation and on its faith and credit, the duty to make monthly interest payments to the $M453_{SM}$ seller over what will usually be a 30-year period, and then to pay the entire principal at the end. For any failure to perform, S.Crow Collateral Corp. would be fully liable to the $M453_{SM}$ seller, and all of S.Crow Collateral Corp.'s assets would be subject to attachment and execution. Those consequences would be nowhere in sight, if the transaction "never in fact took place."

Tax Advisor: Oh, I see.

Assignment of Income

Tax Advisor: I wonder, though: Because it's often the case that S.Crow Collateral Corp. contracts with the seller to buy the asset after the seller has already entered into an agreement to sell to someone else, could the IRS use the doctrine of assignment of income to say that everything was already set in place and the seller-taxpayer can't avoid tax on the income by any change after things were set in place?

Stan Crow: The assignment-of-income doctrine to which you refer has been stated as follows:

> The general principles underlying the assignment of income doctrine are well established. It taxes income "to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." *Helvering v. Horst*, 311 U.S. 112, 119 (1940). Further, "the mere assignment of the right to receive income is not enough to insulate the assignor from income tax liability" where "the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income". *Sunnen*, 333 U.S. 591, 604 (1948). A person cannot escape taxation by anticipatory assignments, however skillfully devised, where the right to receive income has vested. *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941). (As reiterated in *Henrietta v. Rauenhorst*, 119 T.C. 157 (2002)

Do you agree that is a correct statement of the doctrine?

Tax Advisor: I do.

Stan Crow: And so do I. In fact, that doctrine is an important reason why an M453$_{SM}$ -type transaction cannot be used to divert taxable ordinary income from the taxpayer whose activities earned the income, to someone else. However, here's why the doctrine doesn't apply in M453$_{SM}$ transactions: When S.Crow Collateral Corp. purchases a capital asset from a seller who has already contracted to sell to someone else, S.Crow Collateral Corp. *is buying* the asset for valuable consideration, and the seller *does not escape* the income-tax liability; the seller still has the tax liability, but just from a different sale from the one that was first arranged. The due date on the tax payment is deferred, but the liability for the tax remains in place.

Here again, the example of 1031 exchanges demonstrates the correctness of what I'm saying. In 1031 exchanges, it is often (maybe even nearly always) the case that the exchange agreement is signed long after the contract is signed to sell the to-be-relinquished property. Often the exchange agreement is actually signed at the very moment of the closing on the sale of the relinquished property. Nevertheless, no assignment-of-income problem is raised, because the seller's tax liability for the taxable gain on the sale is not removed, but only deferred through the 1031 exchange.

Precisely the same thing is true for sellers in M453$_{SM}$ transactions.

There's one more reason for this result: Especially when it comes to sales of capital assets, the existence of a signed contract to sell does not usually obligate the parties actually to complete the sale. The obligation to sell and buy usually is subject to a number of contingencies, including essential matters such as the existence of unencumbered title to real estate and equipment on the day of the closing, the buyer's ability to bring in the funds with which to buy, the non-occurrence of intervening events such as fire or other damage, the normal continuing of business operations, and so on. Further, even if none of the stated contingencies materializes, the buyer is typically allowed to walk away without closing, on pain of forfeiture of the buyer's earnest money. Therefore, I believe it is appropriate to say that in buy-and-sell-an-asset situations (such as cash sales, 1031 exchanges and installment sales) the right to receive the income from the sale doesn't arise until the sale closes.

It may be different in sell-and-donate-asset situations, in which someone has the legal right to sell something and, to avoid tax on the gain, gives the asset to a charity or family member before the sale closes. In those situations the taxpayer is trying to *avoid* tax on income that the taxpayer has every right to receive.

Tax Advisor: I have no quarrel with that.

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