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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index No.: 453.06-01
CASE MIS No.: TAM-111202-98

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Farm Equipment =

ISSUE:

Whether the Taxpayer's direct sales of Farm Equipment to farmers are transactions described in § 453(l)(2)(A) of the Internal Revenue Code which are excepted from the prohibition on the use of the installment method of accounting by dealers.

CONCLUSION:

The Taxpayer's direct sales of Farm Equipment to farmers are not within the scope of the § 453(l)(2)(A) exception to the prohibition on the use of the installment method of accounting by dealers. The sales may not be reported on the installment method of accounting.

FACTS:

The Taxpayer manufactures and sells Farm Equipment. In addition to sales through a network of dealers, the Taxpayer makes direct sales to farmers. This memorandum is limited to the issue concerning the availability of the installment method of accounting with respect to the Taxpayer's direct sales of Farm Equipment to farmers.

In order to facilitate direct sales of Farm Equipment to farmers, the Taxpayer offers installment terms. The terms are for periods of five to seven years at fixed interest rates significantly lower than those generally available to farmers located in areas of the country where the farm economy is doing poorly. In areas of the country where the farm economy is performing well, the Taxpayer offers interest rates slightly lower than those available from other sources. Customers are able to obtain lower interest rates by foregoing cash discounts. The Taxpayer offers flexible payment schedules structured to accommodate a customer's projected cashflows. The information provided does not indicate how prices on the Taxpayer's direct sales to farmers compare to prices on dealer sales of identical equipment.

LAW AND ANALYSIS:

Section 453(a) provides that except as otherwise provided therein, income from an installment sale shall be taken into account for federal income tax purposes under the installment method of accounting.

Section 453(b)(1) provides that 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.

Section 453(b)(2) provides that the term "installment sale" does not include: any dealer disposition (as defined in § 453(l)); or a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Section 453(l)(1) provides that for purposes of § 453(b)(2)(A) ("installment sales" do not include dealer dispositions) the term "dealer disposition" means any of the following dispositions: (A) any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan; or (B) any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

Section 453(l)(2)(A) provides that the term "dealer disposition" does not include the disposition on the installment plan of any property used or produced in the trade or business of farming (within the meaning of § 2032A(e)(4) or (5)).

The subject issue turns on the interpretation of the words "disposition on the installment plan of property used in the trade or business of farming." Under one view, the provision should be interpreted as applying only to farmers' dispositions of property used or produced in the business of farming. The Taxpayer maintains that the provision is to be interpreted much more broadly to include installment sales of property to farmers for their use in the trade or business of farming. Under that interpretation, manufacturer or dealer sales of virtually any property to farmers on installment terms would qualify for the installment method of accounting.

The literal language of § 453(l)(2)(A) indicates that the provision was intended to benefit farmers by allowing installment reporting of dispositions of property that had been used or produced in the trade or business of farming. In order to interpret the provision as encompassing manufacturer or dealer sales to farmers, it would be necessary to interpret the words "used or produced in the trade or business of farming" to mean "to be used" in the trade or business of farming. There is no evidence that Congress intended the provision to benefit any taxpayers other than farmers.

A review of (1) the history of § 453, (2) the regulations issued under repealed § 453C interpreting language similar to that in § 453(l)(2)(A), (3) Congressional action on farm issues with tax implications, and (4) Congressional response to court decisions having adverse tax consequences for farmers, also supports this interpretation of § 453(l)(2)(A).

Farmers frequently sell livestock or crops on deferred payment terms. In the case of deferred payment sales of livestock, the contracts generally specify the sales price and time for payment. Deferred payment contracts for crops may either specify a price or allow the farmer to lock in a price within specified dates or as of a specific date based on the then current market prices. In some instances, the purchaser's obligation under the deferred payment contract is secured by a standby letter of credit. The contracts are intended to provide tax deferral beyond the taxable year of sale.

In an attempt to preclude farmers from deferring income through the use of deferred payment contracts, the Service has argued that taxation was required in the taxable year of sale either by reason of constructive receipt of the sales proceeds or

cash equivalency of the right to payment under the contract. Schniers v. Commissioner, 69 T.C. 511 (1977)(cotton farmer not in constructive receipt of sales proceeds in year of sale); Crimmins v. U.S., 655 F.2d 135 (8th Cir. 1981)(cattle farmer not required to report income from deferred payment sale of livestock until year of payment); Arnwine v. Commissioner, 696 F.2d 1102 (5th Cir. 1983)(cotton farmer constructively received sales proceeds in year of sale as cotton gin was acting his agent); Warren v. United States, 613 F.2d 591 (5th Cir. 1980)(cotton farmer taxable on proceeds of sale in year of sale as cotton gin was acting as agent of farmer in making sales of cotton); Griffith v. Commissioner, 73 T.C. 933 (1980)(cash method farmer taxable on deferred payment sale in year of sale where purchaser's obligation was secured by a standby letter of credit; receipt of more than 30 percent of sales price in year of sale precluded use of the installment method); Watson v. Commissioner, 613 F.2d 594 (5th Cir. 1980)(cotton farmer taxable on deferred payment sale in year of sale when he received letter of credit, a cash equivalent).

The installment sale provisions of the Code, as in effect prior to 1980, limited the use of the installment method to sales with a fixed and determinable price that was subject to no contingencies. The use of the installment method was elective and was available only if not more than 30 percent of the sales price was received in the year of sale. The terms of farmers' deferred payment contracts, e.g., the absence of a fixed price on price later contracts, receipt of more than 30 percent of the sales price in the year of sale, often precluded qualification for use of the installment method of accounting.

In enacting the Installment Sales Revision Act of 1980 (P.L. 96-471)(the "1980 Act"), Congress significantly reduced the potential for the Service to challenge the tax deferral provided by farmers' deferred payment contracts. The 1980 Act eliminated the limitation on the amount of the sales price that could be received in the year of sale and provided that a third party guarantee would not be taken into account in determining if a purchaser's evidence of indebtedness constituted payment to the seller.

Congress enacted § 453C, the proportionate disallowance rule, as part of the Tax Reform Act of 1986 (P.L. 99-514). Section 453C(e)(1)(B) provided an exception from the proportionate disallowance rule for any installment obligation which arose from the disposition (i) by an individual of personal use property (within the meaning of §1275(b)(3)), or (ii) of any property used or produced in the trade or business of farming (within the meaning of § 2032A(e)(4) or (5)). The proportionate disallowance rule treated a portion of a taxpayer's "allocable installment indebtedness" as a payment on "applicable installment obligations" held by the taxpayer that arose in that taxable year and were still outstanding as of the end of the year.

The legislative history for § 453C indicates that the Senate Finance Committee believed that a taxpayer's borrowings generally were related to its installment obligations in one of two ways. Either the taxpayer would not have undertaken all or a portion of the borrowing but for its extension of credit in connection with the sale of its property or the taxpayer's borrowing ability would be enhanced by the presence of the installment obligations amount the taxpayer's assets. The Committee believed that farm property and personal use property, as well as indebtedness relating to such property, should not be taken into account. S. Rep. No. 313, 99th Cong., 2d Sess. (1986), p. 122-132.

Section 1.453C-7T(c) of the Temporary Regulations issued under § 453C provided:

> For purposes of section 453C and the regulations thereunder, property is used in the trade or business of farming if such property is used by the taxpayer in the trade or business of farming as that term is defined in section 2032A(e)(4) or (5). For this purpose, the term "taxpayer" includes a "farm-related taxpayer," as defined in section 464(f)(3)(B). The term "AIO," within the meaning of §1.453C-2T(a) does not include any obligation arising from the disposition of property used or produced by a taxpayer (or a farm-related taxpayer) in the trade or business of farming.

Section 1.453C-7T(c) of the Temporary Regulation implemented the position evidenced in the report of the Senate Finance Committee. The regulation limited the benefit of the exception from the proportionate disallowance rule to installment obligations arising from dispositions of property used by the taxpayer in the trade or business of farming. The circumstances involving such installment obligations did not entail a farmer undertaking borrowing in order to make a deferred payment sale. Similarly, the deferred payment sales did not enhance the farmer's borrowing ability since deferred payment sales were generally unsecured and frequently did not provide for payment of interest. The sales were not intended to generate arbitrage income on the difference between a farmer's cost of borrowing and interest that could be earned on the deferred payment sale.

Dealer sales of equipment and other property to farmers on installment terms would typically evidence the type of circumstances to which the Senate Finance Committee believed the proportionate disallowance rule should have applied. A farm equipment dealer's sales on installment terms would have enhanced the dealer's borrowing ability since the dealer, generally, would have retained a security interest in the property sold. To the extent the dealer had borrowings, the amount of the borrowings would have been greater than if the dealer had not extended installment

terms to its customers. Dealer's installment terms typically provide for interest at a rate in excess of the dealer's cost of borrowing. The dealer's objectives in making installment sales were twofold: to defer taxes and generate interest income from the customer's installment obligation.

Although the current pledge rules of § 453A address circumstances involving borrowings directly secured by any interest in installment obligations, the legislative history of § 453C is relevant for purposes of determining the interpretation of § 453(l)(2)(A) since the language of that provision was carried over from § 453C(e)(1)(B).

Many of the provisions of the Tax Reform Act of 1986, e.g., elimination of the investment credit, reduction in depreciation deductions, the limitation on investment interest deductions, repeal of provisions allowing the expensing of soil and water conservation expenditures and land clearing expenditures, and reduction of tax rates had the effect of reducing the significance of tax considerations in investment decisions. Tax benefits provided an incentive for investment in farm tax shelters. Tax considerations resulted in unnecessary investment in depreciable farm equipment and buildings. Unnecessary replacement of equipment contributed to an excessive debt burden for farmers. Such investment resulted in purchase and planting of additional acreage. The resulting large crops severely depressed farm prices and land values. [1]

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) repealed the use of the installment method for dealer dispositions occurring after December 31, 1987. Absent the provision of relief, farmers' characterization as dealers by reason of sale of crops and livestock, which is property held for sale in the ordinary course of business, would have precluded their continued use of the installment method. Congress enacted § 453(l) to preclude that result and preserve the availability of the installment method for dealers in timeshares and residential lots. It conditioned use of the installment method for dispositions of timeshares and residential lots on the dealers

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[1]In testimony before the Ways and Means Committee during its consideration of the Tax Reform Act of 1986, C. Allen Bock, Professor of Agricultural Law, College of Agriculture, University of Illinois indicated that the farm economy was experiencing financial distress. Estimates suggested that 15-40 percent of farmers might be undergoing some partial or total liquidation of farm assets. Similarly, the Arkansas delegate to the American Agricultural Movement, Inc. expressed concern that billions of dollars of tax revenue were being lost through "farm for loss" operations. Testimony by an executive of an agricultural equipment manufacturer dealer seeking the preservation of the investment credit for purchases of agricultural equipment on the basis that it benefitted farmers by reducing the cost of equipment prompted a comment that investment credit was an inefficient means of assisting farmers, particularly since investment credit would provide minimal benefit to farmers [illegible]

making an election to pay an interest charge on the tax deferred through the use of the installment method. Congressional action to provide continued availability of the installment method to farmers without imposition of the interest charge on deferred tax was consistent with a long history of Congressional action directed toward the preservation of the family farm. However, there is no indication Congress intended to extend that favorable treatment to other dealers, i.e., dealers who sold property to farmers.

Section 453(l)(2)(A) provides that the term "dealer disposition" does not include the disposition of on the installment plan of any property used or produced in the trade or business of farming (within the meaning of § 2032A(e)(4) or (5). The language in § 453(l)(2)(A) is identical to that used in § 453C(e)(1)(B)(ii). Consequently, there is no reason to interpret § 453(l)(2)(A) more expansively than § 1.453C-7T(c) of the Temporary Regulations interpreted the identical language.

In light of the literal language of § 453(l)(2)(A), the legislative history of § 453C, the testimony before the Ways and Means Committee, and the absence of any indication that Congress intended to provide preferential treatment for dealers' sales to farmers, it is difficult to maintain that Congress intended to allow installment reporting for dealers' sales to farmers. It has been suggested that Congress anticipated that the dealers would pass the benefit of the tax savings facilitated through their use of the installment method through to farmers. While such action would be possible, there was no assurance that it would take place. Given its refusal to continue the investment credit for farmers' purchases of equipment on the basis that it would represent an inefficient means of providing assistance to farmers, it is doubtful Congress would have viewed allowance of the use of the installment method by dealers who sold property to farmers in the expectation that farmers would receive some benefit from such treatment to be an efficient means of assisting farmers.

The position advocated by the Taxpayer is also inconsistent with the trend of Congressional action to further restrict the use or benefit of the installment method of accounting. The Tax Reform Act of 1986 enacted the proportionate disallowance rule and prohibited the use of the installment method for sale of publicly traded property and sales under a revolving credit plan. The Omnibus Budget Reconciliation Act of 1987 continued the trend by repealing the use of the installment method for dealer dispositions (the proportionate disallowance rule was correspondingly repealed) and enacting §453A(d)(the pledge rule) and § 453A(a)(provision for an interest charge on installment obligations arising from the disposition of real property to the extent the amount of such obligations exceeds $5 million). The Technical and Miscellaneous Revenue Act of 1988 expanded the scope of § 453A(a) and provided for promulgation

of regulations to prevent the avoidance of § 453A through the use of related persons, pass-through entities or intermediaries. The Taxpayer Relief Act of 1997 repealed § 811(c)(2) of the Tax Reform Act of 1986 which allowed the use of the installment method for certain manufacturers' sale to dealers. An expansive interpretation of § 453(l)(2)(A) would be inconsistent with the trend of Congressional action affecting the availability of the installment method of accounting.

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