

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:ITA:B04:
GL-148802-03

Number: **200423028**
Release Date: 6/4/04

UILC: 453.05-00
3402.00-00

date: March 30, 2004

to: Nancy Hale, Associate Area Counsel
(Small Business/Self-Employed)
Attn: Edsel Ford Holman, Jr.
Senior Counsel
(Small Business/Self-Employed)

from: Robert M. Brown
Associate Chief Counsel
(Income Tax & Accounting)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer 1 =

Taxpayer 2 =

X =

Y =

XY =

Trust =

F =

Year 1 =

Year 2 =

Year 3	=
Year 4	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
State 1	=
State 2	=
State 2 Lottery	=
D	=
E	=
F	=
G	=
Court	=

ISSUES

1. Whether contingent installment notes that Taxpayer 1 and Taxpayer 2 (collectively, "Taxpayers"), received (in separate transactions) in exchange for certain future periodic payments of lottery winnings were "evidence[s] of indebtedness of a person other than the person acquiring the property from the taxpayer[s]" within the meaning of § 15a.453-1(b)(3) of the Temporary Regulations under the Installment Sales Revision Act of 1980.
2. Where taxpayers assigned their rights to lottery prize winnings to Trust, which party is entitled to the taxes withheld pursuant to § 3402(q)(1) of the Internal Revenue Code.

CONCLUSIONS

1. The contingent installment notes that Taxpayers received were not evidences of indebtedness of a person other than the person that acquired the property from Taxpayers under § 15a.453-1(b)(3). Instead, the notes that Taxpayers received are evidences of indebtedness of the person acquiring the property under § 453(f)(3) and 15a.453-1(b)(3).¹

2. Trust is entitled to taxes withheld pursuant to § 3402(q)(1) because it was assigned the rights to Taxpayers' lottery prize winnings.

FACTS

X and Y, d/b/a XY, are State 1 limited liability companies. XY is in the business of originating, warehousing and securitizing various assets. XY offers a program under which individuals who have the right to receive certain discrete, periodic payments of cash may sell all or a portion of the future periodic payments to XY or a trust that XY sponsors in exchange for non-negotiable, non-assignable installment notes. X seeks out individuals who wish to sell their rights to certain future periodic payments. In the facts presented, the future periodic payments are lottery prize winnings.

In Year 1, Taxpayer 1 and Taxpayer 2 held the winning ticket to the State 2 lottery and were each entitled to one half of the \$D jackpot. Both Taxpayer 1 and Taxpayer 2 received their winnings in periodic payments that were to be paid through Year 4.

In Year 2, Taxpayer 1 and Taxpayer 2 each entered into separate sale agreements under which each agreed to sell to X her respective remaining periodic payments of the lottery prize, which were due to be paid commencing in Year 3 and ending in Year 4 (the "Remaining Lottery Payments"). The sale agreements provided that X could assign to a third person all or a portion of its rights under the sale agreements, provided that X would continue to be bound to pay Taxpayers the purchase price for their Remaining Lottery Payments. X's obligation to purchase the Remaining Lottery Payments was subject to several conditions precedent, including the issuance of a court order directing the State 2 Lottery to recognize the sale agreements and make the Remaining Lottery Payments, without reduction or set-off (other than income tax withholding), directly to X or its named assignees pursuant to the sale agreements.²

The sale agreements also provided that, contemporaneous with their execution, X would organize Trust and that, upon completion of its organization, Trust would proceed

¹ For purposes of this memorandum we have assumed that contingent installment notes are not, under applicable principles of law, a retained interest in the property that is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation, or similar transaction. See § 15a.453-1(c)(1).

² State 2 law provides that a lottery prize winner may voluntarily assign all or part of a lottery prize only pursuant to a court order meeting certain requirements.

to purchase all of the Remaining Lottery Payments in exchange for two promissory notes.³ The sale agreements set forth the approximate amount of the notes that Trust would issue in exchange for the Remaining Lottery Payments and indicated that the amount of payments Taxpayers would receive under the notes would be determined with reference to “investments selected by” Taxpayers. The sale agreements also provided that Taxpayers could not cancel the agreements after the expiration of a cancellation period, and that the agreements were deemed an equitable lien on the Remaining Lottery Payments.

The day after the sale agreements were signed, X assigned to Trust all of its rights, title, and interest in the (i) sale agreements (with the exception of one right not relevant to this issue) and (ii) Remaining Lottery Payments, as identified in the sale agreements. The assignment was signed by representatives of X and Trust.

Subsequently on Date 1, Trust was organized as a Delaware Business Trust with X as its sponsor.⁴ On Date 2, the Court confirmed and approved the Taxpayers' assignments to X and its successors and assigns of all rights, title, and interest in the Remaining Lottery Payments (including the right to exercise the cash out options offered by State 2) and the agreement under which X transferred the Remaining Lottery Payments to Trust.⁵ In addition, the Court ordered the State 2 Lottery to pay the Remaining Lottery Payments to Trust.

On Date 3, Trust submitted a request to the State 2 Lottery for a conversion of the Remaining Lottery Payments into a lump sum payment. The State 2 Department of Revenue paid Trust \$E in satisfaction for both lottery prizes. On Date 4, Trust issued to Taxpayers its non-negotiable, non-assignable installment notes in exchange for the lump sum payment (less the amount of Federal and state tax withholdings).

The State 2 Department of Revenue withheld \$E in federal taxes from the lump sum payment. Trust filed a Form 4466, Corporation Application for a Quick Refund of Overpayment of Estimated Tax, with the Service, claiming a refund of the entire tax withheld by the State 2 Department of Revenue, and attached the Forms W-2 issued by the Department of Revenue. The Service allowed the refund in full and issued a payment of \$E to Trust. On Date 5, Trust issued to Taxpayers its non-negotiable, non-assignable installment notes in exchange for the amount of federal taxes withheld from the lump sum payment.

³ As discussed below, however, Taxpayer 1 and Taxpayer 2 each received three installment notes in exchange for assigning their Remaining Lottery Payments.

⁴ Trust files Form 1120, U.S. Corporation Income Tax Return, for federal income tax purposes.

⁵ It is unclear whether Trust existed as of the date it entered into the assignment agreement with X. It is clear, however, that Trust was in existence when the Court approved the assignment agreement between X and Trust.

The information we have received indicates that Trust had applied for a refund of State 2 taxes that were withheld from the lump sum payment. After Trust receives the refund of State 2 taxes, it will issue to Taxpayers its non-negotiable, non-assignable installment notes in exchange for the amount of State 2 taxes withheld from the lump sum payment.

The installment obligations issued by Trust have a final maturity date of Date 6. They shall immediately be paid in full, however, upon the death of Taxpayers or a successful challenge binding on Taxpayers by the Service resulting in current inclusion of the purchase price of the lottery prize payments. The principal amount of any payment is the lesser of a specified amount or the amount determined by reference to an "investment menu" selected by the Taxpayers. Taxpayers may change the investment menu on a monthly basis. The installment obligations are credit enhanced by an irrevocable standby letter of credit issued by F, which is a general unsecured obligation of F. The standby letter of credit is non-negotiable and non-transferable and can be drawn upon only upon a default under the installment obligations. The installment obligations are also guaranteed by Y.

Trust's Year 2 tax year was examined, and an adjustment was proposed against Trust for the entire withholding it received as a refund from the Service. Although the agent agrees that Trust is entitled to the lump sum payment it received from the State 2 Department of Revenue, the agent does not believe that Trust is entitled to any amount of taxes withheld by the State 2 Department of Revenue. To support this, the agent relies on petitions filed with Court in both cases, which state that the sale agreements between Taxpayer 1 and Trust and between Taxpayer 2 and Trust do not include federal tax withholding. See Exhibit 7, page 30 and Exhibit 8, page 5. It is unclear whom, if anyone, the agent believes should be entitled to the withholding credits.

LAW AND ANALYSIS

Installment Notes are not Third-Party Obligations

Section 453(a) provides that income from an installment sale shall be taken into account under the installment method.

Section 453(b)(1) provides that, for purposes of § 453, 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(f)(3) and § 15a.453-1(b)(3) provide that, except as provided in § 453(f)(4), the term "payment" does not include the receipt of an evidence of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person).

Section 15a.453-1(b)(3) also provides that, except as provided in § 15a.453-2 (relating to distributions of installment obligations in corporate liquidations described in § 337), "a

payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer.”

X and Taxpayers executed sale contracts, whereby Taxpayers agreed to assign all of their rights to their Remaining Lottery Payments to X or one of its affiliates in exchange for non-negotiable, non-assignable installment notes. Pursuant to the terms of an assignment agreement, and as contemplated by the sale contracts, X subsequently assigned to Trust all of its rights and obligations under the contracts. X also obtained a court order granting the assignment of the Remaining Lottery Payments from Taxpayers to Trust. Thus, it appears that X assigned to Trust pursuant to the sale agreements its rights to the Remaining Lottery Payments and that X never owned the Remaining Lottery Payments. Under this approach, Trust acquired ownership of the Remaining Lottery Payments from Taxpayers on Date 2, the date on which the sale was completed. A number of factors support the contention that the sale was completed on this date. First, on Date 2, Court granted the order recognizing the sale agreements and the assignment of the Remaining Lottery Payments to Trust. As a result of this assignment, Trust acquired an equity interest in the Remaining Lottery Payments. Moreover, the terms of the contract entered into by X and Taxpayers contemplated the court order as the final required step prior to finalization of the sale agreements. Finally, pursuant to State 2 law, Trust was entitled to sell the Remaining Lottery Payments in a subsequent sale following the order granting the assignment. See Grodt & McKay Realty, 77 T.C. 1221 (1981). Furthermore, the completion of the sale was not postponed merely because the purchase price had been deferred by installment payments. See Merrill v. Commissioner, 40 T.C. 66 (1963).

Therefore, under the plain language of § 453(f)(3) and § 15a.453-1(b)(3), the installment notes were issued by the person (*i.e.*, Trust) acquiring the property (*i.e.*, Remaining Lottery Payments) from the seller (*i.e.*, Taxpayers).

Withheld Federal Taxes

Section 3402(q)(1) provides that every person, including the Government of the United States, a State, or a political subdivision thereof, or any instrumentalities of the foregoing, who makes any payment of winnings which are subject to withholding, shall deduct and withhold from the payment an amount equal to the product of the third lowest rate of tax applicable under § 1(c) and such payment.

Section 3402(q)(3)(B) provides that “winnings which are subject to withholding” includes proceeds of more than \$5,000.00 from a wager placed in a lottery with an authorized employee or agent of a State agency that is conducted by an agency of a State acting under authority of State law.

Section 3402(q)(4)(A) provides that proceeds from a wager shall be determined by reducing the amount received by the amount of the wager.

In this case, State 2 conducted the lottery. Both Taxpayer 1 and Taxpayer 2 held winning tickets for the lottery, the proceeds of which were paid in installments. The proceeds from Taxpayer 1 and Taxpayer 2's respective winning wagers exceed \$5,000.00. Thus, any proceeds from Taxpayer 1 or Taxpayer 2's winning lottery wager meet the definition of winnings which are subject to withholding contained in § 3402(q)(3)(B).

Taxpayer 1 and Taxpayer 2 assigned their respective Remaining Lottery Payments to Trust. Each assignment gave Trust the right to any subsequent payments from State 2 Department of Revenue. In Year 2, the State 2 Department of Revenue made a payment of \$G to Trust as the assignee of Taxpayer 1, and a payment of \$G to Trust as the assignee of Taxpayer 2.

For purposes of § 3402(q)(1), the State 2 Department of Revenue is a person. As such, the State 2 Department of Revenue withheld federal taxes from both payments.

These withholdings are payments of tax made to the Service on behalf of Trust. Trust would then use these withholding credits to satisfy its Year 2 tax liability. If Trust's tax liability is less than the amount of taxes withheld by the State 2 Department of Revenue, Trust is entitled to an overpayment, which may be refunded as provided in § 6402.

Assuming Trust had any agreement to pay amounts withheld to a third party, Trust would make such payments after it receives the refund from the Service. Enforcement of any such agreement would be between Trust and the third party.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under any provision of the Internal Revenue Code, including §§ 453, 3402, and 6402.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4920 if you have any further questions.