Griffith v. Commissioner, 74 T. C. 730 (1980)

A standby letter of credit, even if nontransferable, can be considered the equivalent of cash for tax purposes if its proceeds can be assigned and there are no significant contingencies to payment.

Summary

In Griffith v. Commissioner, the Tax Court ruled that the Griffiths, who sold cotton under a deferred payment contract secured by a nontransferable standby letter of credit, realized income in the year of sale. The court found that the letter of credit's proceeds were assignable under state law, and there were no meaningful contingencies to payment, thus equating it to cash. The Griffiths could not use the installment method to defer income recognition because the letter of credit was considered a payment exceeding 30% of the sale price in the year of sale. This decision highlights the tax implications of secured payment arrangements and the importance of assignment rights in determining income realization.

Facts

In 1973, J. K. and Erma Griffith, along with their son Curtis and daughter-in-law Cynthia, sold a large quantity of cotton they had accumulated from prior years. They entered into a deferred payment contract with Dunavant Enterprises, Inc. , where the total purchase price of $3,376,508 was to be paid in installments from 1975 to 1979, with interest. The contract was secured by a nontransferable standby letter of credit issued by First National Bank of Memphis, payable upon certification of Dunavant's default. The Griffiths did not report this income in their 1973 tax returns, but the IRS asserted deficiencies, claiming the letter of credit constituted realized income in 1973.

Procedural History

The Griffiths filed petitions with the Tax Court contesting the IRS's deficiency determinations. The court's decision focused on whether the Griffiths had realized income in 1973 and whether they could use the installment method for reporting the income from the cotton sale.

Issue(s)

1. Whether the Griffiths realized income from the sale of cotton in 1973 when they received a nontransferable standby letter of credit as payment.
2. Whether the Griffiths were entitled to elect the installment method for reporting the income from the cotton sale.

Holding

1. Yes, because the standby letter of credit was the equivalent of cash as its

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proceeds were assignable and there were no significant contingencies to payment.
2. No, because the letter of credit was considered a payment exceeding 30% of the sale price in the year of sale, disqualifying the Griffiths from using the installment method.

Court’s Reasoning

The court reasoned that the standby letter of credit, though nontransferable, was equivalent to cash because its proceeds were assignable under Texas and Tennessee law. The court distinguished between the transferability of the letter itself and the assignability of its proceeds, finding that the latter was permissible despite the former’s restriction. The court cited Watson v. Commissioner, emphasizing that the Griffiths had fully performed their obligations and the letter of credit was merely a means of securing future payments, not contingent on further performance. The court rejected the Griffiths’ arguments about practical transferability, noting the lack of business purpose for the nontransferability clause and its apparent intent to manipulate tax consequences. Regarding the installment method, the court likened the letter of credit to an escrow arrangement, as in Oden v. Commissioner, where the security arrangement was considered a payment in excess of 30% of the sale price, thus disqualifying the seller from using the installment method.

Practical Implications

This decision impacts how deferred payment contracts secured by letters of credit are treated for tax purposes. It establishes that even a nontransferable standby letter of credit can be considered realized income if its proceeds are assignable and there are no significant contingencies to payment. Taxpayers must carefully consider the assignability of payment security instruments when structuring sales to avoid unintended income recognition. This case also limits the use of the installment method when payment security is considered a payment in the year of sale. Practitioners should advise clients on the tax implications of various payment arrangements and consider the potential for income realization based on the assignability of security instruments. Subsequent cases have cited Griffith when analyzing similar secured payment arrangements and their tax treatment.

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