

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

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LEGEND:

A =

B =

C =

D =

E =

F =

G =

H =

Buyer =

Merger Agreement =

Trust =

Trust Agreement =

State =

date 1 =

date 2 =

date 3 =

x =

y =

Dear Mr.

This is in reply to your June 27, 2002, request for rulings that the transactions discussed below will qualify for installment sale treatment under § 453 of the Internal Revenue Code.

FACTS:

Taxpayers A, C, D, E, F, and G (the “Sellers”) owned or operated 29 nursing homes and assisted living facilities within State.¹ Taxpayers wished to sell their assets to Buyer, a State nonprofit corporation under § 501(c)(3). The sales transactions would be effected through mergers of the Taxpayers into Buyer, and the issuance of Notes and Bonds to their shareholders and members. Pursuant to § 1.7 of a Merger Agreement, each of the shareholders or members of the Taxpayers elected on date 1 to receive a combination of Subordinated Promissory Notes and Bonds. On date 2, Taxpayers merged into Buyer, and Buyer issued Notes totaling \$x to the shareholders or members of Taxpayers. The Notes will bear interest at an initially fixed payment rate of 6 percent per annum and an accrual interest rate of 14 percent per annum, and will have maturities of 17 years.

Subsequently, on date 3, development authorities of political subdivisions (the “Authority”) within State issued qualified § 501(c)(3) Bonds totaling \$y to Taxpayers’ shareholders and members. The Bonds were not issued in exchange for any of the Notes issued on date 2. Further, no cash proceeds from the Bonds were paid to satisfy prior installment obligations of Buyer to the shareholders or members of Taxpayers.

In exchange for issuance of the Bonds by Authority, Buyer executed promissory notes (“Buyer Bond Indebtedness”) for the face amount of the Bonds to Authority. Buyer’s Bond Indebtedness issued to Authority has the same term as the Bonds issued by Authority to Taxpayers and provides for the same rate of interest.² The Bonds contain restrictions on transferability and a provision precluding prepayment for 5 years from date of issuance. The Bonds will not be registered on any securities exchange. In addition, Authority will have no obligation to provide any funds to satisfy the Bond

¹ B is a sole shareholder of A. H is an individual that directly or indirectly owns interests in each of the Taxpayers.

² Buyer does pay a nominal amount to cover trustees’ fees under the Bonds.

obligations. The Authority will transfer its rights to a trustee for the benefit of Taxpayers' shareholders and members, and the trustee will service the Bonds. The Bonds were issued in order for Buyer to finance the acquisition of Taxpayers' nursing homes and assisted living facilities at the lowest available interest rate.

The shareholders of C, due to its small size, decided that Trust would be formed to hold the Notes and Bonds attributable to the merger of C into Buyer. Taxpayers represent that Trust is a liquidating trust under § 301.7701-4(d) of the Procedure and Administration Regulations and also is a grantor trust. Under § 4 of the Trust Agreement, the shareholders of C remain obligated to report all of their gains on their respective shares of the Notes and Bonds.

In supplemental information dated December 6, 2002, you withdrew ruling request number 1 and asked instead that the ruling letter assume the following:

[T]he mergers of the [Taxpayers] ... with and into Buyer are considered as sales by the [Taxpayers] ... of all of their respective assets to Buyer in exchange for the Installment Notes and the Bonds or Additional Subordinated Promissory Notes followed by a deemed distribution of the Subordinated Promissory Notes and the Bonds or Additional Subordinated Promissory Notes by such [Taxpayers] ... to their respective shareholders or members in complete liquidation of each of the [Taxpayers]....

LAW AND ANALYSIS:

Section 453(a) provides that income from an installment sale shall be taken into account under the installment method. The term "installment sale" is defined by § 453(b)(1) to mean 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.

Under § 453(f)(3) the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property. However, under § 453(f)(4) the receipt of a bond or other evidence of indebtedness that is payable on demand or readily tradable shall be treated as receipt of payment.

Section 453(h)(1)(A) provides that if, in a liquidation to which § 331 applies, the shareholder receives (in exchange for the shareholder's stock) an installment obligation, acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligations) by the shareholder shall be treated as the receipt of payment for the stock.

Under § 453B(a) if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, or (2) the fair market value of the obligation.

Section 453B(h) provides that if an installment obligation is distributed by an S corporation in a complete liquidation, and receipt of the obligation is not treated as payment for the stock by reason of § 453(h)(1), then, except for purposes of any tax imposed by subchapter S, no gain or loss with respect to the distribution of the obligation shall be recognized by the distributing corporation.

Section 671 provides that where it is specified in subpart E that the grantor or another person shall be treated as the owner of any portion of a trust, there then shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 of the Code in computing taxable income or credits against the tax of an individual.

Section 1.671-2(c) of the Income Tax Regulations provides that an item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under § 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual).

Section 677(a) provides, in part, that the grantor shall be treated as the owner of any portion of a trust, whether or not the grantor is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; or (2) held or accumulated for future distribution to the grantor or the grantor's spouse.

Section 301.7701-4(d) of the Procedure and Administration Regulations provides that certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Following are your seven ruling requests and our analysis and conclusions relating to each ruling.

(1) The Bonds to be issued by the Authority are to be treated as indebtedness of the Buyer for purposes of § 453(f)(3) and are not to be considered readily tradable in an established securities market for purposes of § 453(f)(4) and (5). Therefore, the receipt of the Bonds by the shareholders or members of the Taxpayers will not constitute payment to the Taxpayers or to the shareholders or members of the Taxpayers for purposes of § 453(b)(1).

Although the Bonds will be issued by Authority and not Buyer, the Bonds will have the same terms, in all material respects, as Buyer's Notes (amount, term, interest rate, etc.). Buyer's payments on the additional, separate notes (Buyer Bond Indebtedness) that Buyer executed to Authority will be the sole funding source for debt service on the Bonds. Further, Authority will have no obligation to provide other funds to satisfy the Bond obligations. The Bonds contain restrictions on transferability and will not be registered on any securities exchange. Thus, under § 15A.453-1(e)(4) of the temporary Income Tax Regulations the Bonds are not readily tradable in an established securities market.

Because of the close similarity between the Bonds and Buyer's Notes, the Bonds issued by Authority will be considered as the obligation of Buyer. Thus, the receipt of the Bonds by the Taxpayers or shareholders or members of Taxpayers will be treated as the receipt of the indebtedness of Buyer for purposes of § 453(f)(3) and will not constitute payment to the Taxpayers or the shareholders or members of Taxpayers for purposes of § 453(b)(1).

(2) The sales of the nursing homes and assisted living facilities will qualify as installment sales under § 453(b)(1).

Under § 453(b)(1) an "installment sale" is a disposition of property if at least one (monetary) payment is to be received after the close of the taxable year in which the disposition occurs. The Taxpayers' receipt of the Buyer's Notes and Bonds is treated as the receipt of the indebtedness of the Buyer acquiring the property, and neither the Notes or Bonds themselves constitutes a "payment" under § 453(f)(3). The Notes have maturities of 17 years. Thus, the sale at issue is a sale of property in which at least one payment will be received after the close of the year of sale, and is therefore an installment sale within the meaning of § 453(b)(1).

(3) No gain or loss shall be recognized by any of the Taxpayers (except for purposes of any tax imposed by subchapter S) on the deemed distribution of the Notes and Bonds by such Taxpayers to their respective shareholders or members in liquidation.

Taxpayers distributed Notes and Bonds to their respective shareholders or members in liquidation pursuant to § 331. Under § 453(h)(1)(A) the receipt of such obligations (as opposed to receipt of payments under such obligations) is not treated as the receipt of payment for the stock of the shareholders or members. Accordingly, under § 453B(h), except for purposes of any tax imposed by subchapter S, no gain or loss shall be recognized by any of the Taxpayers on the deemed distribution of the Notes and Bonds by such Taxpayers to their respective shareholders or members in liquidation.

(4) Any payment received pursuant to the Notes or Bonds by a shareholder of a Taxpayer that is a corporation will not be treated as payment to the Taxpayer but will be treated as payment to the shareholder for that shareholder's stock.

Since the shareholders of Taxpayers that are corporations will receive Buyer's Notes and Bonds (in exchange for the shareholders' stock) in a liquidation to which § 331 applies, under § 453(h)(1)(A) the receipt of payments under such obligations by the shareholders will not be treated as payment to the Taxpayers but will be treated as the receipt of payment for the shareholders' stock.

(5) Any payment received pursuant to the Notes or Bonds by a member of a Taxpayer that is a partnership will have the character such payment would have had in the hands of the Taxpayer from whom such installment obligation was acquired.

Taxpayer F is a partnership for federal income tax purposes. Under § 1.453-9(c)(2) no gain or loss is recognized to F on the distribution to a partner of an installment obligation. Therefore, under § 1.453-9(c)(3) any payment received by a partner of F pursuant to the Buyer's Notes or Bonds will have the character such payment would have had in the hands of F, i.e., income from an installment sale.

(6) Any payment received pursuant to the Notes or Bonds by Trust and distributed by the trustee thereof to a Taxpayer beneficiary of such Trust will have the character such payment would have had in the hands of such Taxpayer had the Taxpayer received the payment directly.

The shareholders of C formed Trust to hold the Notes and Bonds attributable to the merger of C into Buyer. Under § 1.671-2(c), an item of income of a grantor is treated as if it had been received directly by the grantor. Taxpayer has represented that Trust is a valid liquidating trust under § 301.7701-4(d) and a valid grantor trust under § 671. Therefore, any installment payment received by Trust pursuant to the Buyer's Notes or Bonds and distributed by the trustee to a shareholder or member of C will have the same character as if the payment was received directly by the shareholder or member of C. No opinion is expressed or implied concerning whether Trust is a valid liquidating trust under § 301.7701-4(d) or whether Trust is a valid grantor trust under § 671. If

Trust fails to be a liquidating trust or a grantor trust, this ruling will be null and void.

(7) The “directed” transfer by C shareholders assigning their respective rights under the Agreement to their Notes or Bonds to the trustee of Trust will not result in a disposition under § 453B.

Under § 4 of the Trust Agreement, the C shareholders, by retaining a right to the deferred profit in the Notes and Bonds received by Trust, remain taxable on the Notes and Bonds. Accordingly, since the C shareholders are treated as the owner of the portion of Trust consisting of the deferred profit, the transfer in trust of the Notes and Bonds is not a § 453B disposition of the installment obligations. Rev. Rul. 67-70, 1967-1 C.B. 106. The C shareholders must report the gain from the sale of the property on the installment method of accounting as if Trust were not in existence. Rev. Rul. 74-613, 1974-2 C.B. 153.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)