Internal Revenue Service

Number: **200521007**
Release Date: 5/27/2005
Index Number: 453.00-00, 453.08-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-150148-04
Date:
February 25, 2005

In Re:

Legend

A =
B =
X =

Y =
Date 1 =
Date 2 =
z =

Dear :

This is in reply to your request for a private letter ruling to allow the taxpayer, *X*, to revoke the election out of the installment method under § 453(d)(3) of the Internal Revenue Code and § 15a.453-1(d)(4) of the Income Tax Regulations.

FACTS:

X is an S corporation with two shareholders, *A* and *B*. *X* and *Y* entered into an Asset Purchase Agreement (Agreement) dated Date 1. In accordance with the Agreement, *Y* transferred $*z* of the purchase price to an escrow account. This amount was held in escrow for a period of 2 years until Date 2 to protect and indemnify *Y* for any breach of warranty, covenant, or representation under the Agreement by *X*. All proper claims submitted during the defined time period were to be paid out of the escrow funds. On Date 2, all remaining funds in the escrow account were to be disbursed to *X*, less any pending claims. During the term the escrow account was in existence, interest was paid quarterly to *X*.

X retained an accounting firm to prepare the tax returns for the year that included the sale of *X*'s assets under the Agreement. *X* provided the accounting firm with the Agreement and all documents pertaining to the sale. The accounting firm advised *A* and *B* that the sale was not eligible for installment sale treatment. Accordingly, *X*'s tax return was prepared without utilizing the installment method.

Subsequently, *X* hired another accounting firm and upon inspection of the previously filed tax return and sale documents, the new accountants believe that *X* would have been eligible to utilize the installment sale rules and have prepared this request to revoke the election out of the installment method. *X* has represented that there was no intention on its part to elect out of the installment method and that the request for the change is not due to hindsight.

LAW AND ANALYSIS

Section 453(a) provides that income from an installment sale shall be taken into account under the installment method. Section 453(b)(1) defines the term "installment sale" to mean a disposition of property if at least one payment is to be received after the end of the taxable year in which the disposition occurs. The term "installment method" is defined in § 453(c) as a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year that the gross profit (realized or to be realized when the payment is completed) bears to the total contract price.

Section 15a.453-1(b)(3)(i) defines payment to include amounts actually or constructively received in the taxable year under an installment obligation.

Pursuant to § 453(d)(1) and § 15a.453-1(d)(1), a taxpayer may elect out of the installment method in accordance with the manner prescribed by regulations. Under § 15a.453-1(d)(3), a taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on a timely filed tax return for the taxable year in which the installment sale occurs is considered to have elected out of using the installment method.

Except as otherwise provided in the Income Tax Regulations, § 453(d)(2) requires a taxpayer who desires to elect out of the installment method to do so on or before the due date (including extensions) of the taxpayer's federal income tax return for the taxable year of the sale. Pursuant to § 15a.453-1(d)(4), generally, an election under § 453(d)(1) is irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. A revocation of an election out of the installment method is retroactive and will not be permitted when one of its purposes is the avoidance of federal income taxes. See § 15a.453-1(d)(4).

Rev. Rul. 77-294, 1977-2 C.B. 173, states that if an escrow arrangement incident to a deferred payment sale transaction imposes a substantial restriction, in addition to the payment schedule, upon the seller's right to receipt of the sale proceeds, then the Service will allow the seller to use the installment method of reporting income from the sale, assuming the sale transaction otherwise qualifies under § 453.

Rev. Rul. 79-91, 1979-1 C.B. 179, states that in order for an escrow arrangement to impose a substantial restriction, it must serve a bona-fide purpose of the purchaser, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the purchaser.

Generally, the deposit of funds by a purchaser into an escrow account results in the constructive receipt of such funds by the seller if the funds are not subject to substantial conditions or restrictions other than time of payment and the seller expects to collect from the funds placed in escrow. See Oden v. Commissioner, 56 T.C. 569, 576-7 (1971). If the escrowed funds are constructively received by the seller, then the use of the installment method may be denied to the seller. However, if the seller's right to enjoy the trust or escrow funds is subject to a substantial restriction or condition, then the taxpayer is not currently taxable under the economic benefit theory. See Stiles v. Commissioner, 69 T.C. 558, 569 (1978), acq., 1978-2 C.B. 3.

X's access to the funds in the escrow account was limited to quarterly interest payments during the time period of the escrow agreement. Additionally, the funds also protected *Y* against a breach of the Agreement by *X.* Because the escrow agreement was subject to substantial restrictions in accordance with Rev. Rul. 77-294 and Rev. Rul. 79-91, *X* was eligible to utilize installment sale treatment in connection with the sale of assets provided all other requirements under § 453 are met.

X supplied the accounting firm with the necessary documents, and the accounting firm prepared the tax return reporting all gain from the sale in that year. When the new accountants discovered the tax returns had been prepared electing out of the installment method, a request to revoke the election out of the installment method was prepared. The information submitted indicates that *X*'s desire to revoke the election is due to inadvertence rather than hindsight by *X* or a purpose of avoiding federal income taxes. Based on a careful consideration of all the information submitted and representations made, we conclude *X* may revoke the election out of the installment method of reporting under § 453(d)(3).

Permission to revoke the election out of installment method reporting for the sale at issue is granted for the period that ends 75 days after the date of this letter. To revoke the election out of the installment method for the sale at issue *X* must file an amended federal income tax return for the taxable year of the sale and any previously filed return on which a portion of the gain from the sale is reportable under the installment method. A copy of this letter must be attached to the amended returns. 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 transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

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

Enclosures (2)