

Internal Revenue Service

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Person To Contact:

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Telephone Number:

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LEGEND

Taxpayer =

Corp A =

Corp 1 =

Corp 2 =

Corp 3 =

Corp 4 =

Corp 5 =

Individual C =

Individual D =

Individual E =

Trust F =

Trust G =

Trust H =

Buyer =

\$m =

\$n =

\$p =

\$r =

\$s =

\$t =

\$u =

\$v =

\$w =

\$x =

y% =

z% =

Date 1 =

Year 1 =

Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =

Dear _____ :

This is in reply to Taxpayer's request for a ruling requesting permission to use an alternative method of basis recovery under § 15a.453-1(c)(7)(ii) of the Temporary Regulations under the Installment Sales Revision Act of 1981 to report payments from a contingent payment sale. In accordance with § 15a.453-1(c)(7)(ii), Taxpayer filed its ruling request prior to the due date (including extensions) of its Year 1 tax return.

FACTS

Taxpayer uses the accrual method of accounting and has represented that it has been approved to file its federal income tax return on a fiscal year basis as a "grandfathered fiscal year". See section 5.09 of Rev. Proc. 2006-46, 2006-2 C.B. 859, 865. Taxpayer, an S corporation, formerly named Corp A, is the owner of Corp 1, a qualified subchapter S subsidiary that is not treated as a separate corporation. Corp 1 is the 100-percent owner of Corp 2. Also, Taxpayer is the owner of Corp 3, a qualified subchapter S subsidiary that is not treated as a separate corporation. Taxpayer is owned by Individual C, Individual D, Individual E, Trust F, Trust G, and Trust H. Corp 4 and Corp 5 are S corporations that file separate tax returns from the Taxpayer. All six corporations are listed as Sellers on the Asset Purchase Agreement (APA) described below. This letter, however, only addresses the tax consequences to Taxpayer, which includes Corps 1-3.

On Date 1, Taxpayer, as one of the Sellers, entered into the APA that was structured as an installment sale. The terms of payment and the relevant facts are summarized below.

The APA provides that in exchange for selling substantially all of the business assets, Taxpayer had the right to receive:

- (1) \$m closing payment to be released to Taxpayer on the closing date, Date 1.
- (2) Up to \$m "Earnout Amount"
 - a. y% payable to Taxpayer in two equal installments (Year 2 and Year 3) if the business earnings before taxes (EBT) equals or exceeds the base year EBT.

- b. A fraction of the earnout payment for the applicable year in the earnout period (Year 2 and Year 3) if the business EBT is less than the base year EBT but greater than the minimum threshold.
- c. No earnout payment if business EBT is less than the minimum threshold.
- d. If the Taxpayer does not earn the full earnout payment in the two year period, an extra year is added to the period and the same formulas are followed to determine if any payout may be received in the following year.

(3) Up to \$m “Earnup Amount”

- a. Maximum annual earnup paid over three years (Year 4, Year 5 and Year 6) following the earnout period if business EBT equals or exceeds z% minimum growth threshold for earnup year.
- b. A fraction of the maximum annual earnup payment in each of the earnup years if the business EBT is less than z% minimum growth threshold but greater than the EBT growth threshold.
- c. No earnup payment will be made if business EBT is less than the EBT growth threshold in any earnup year.
- d. If Taxpayer does not earn the full earnup amount in the three year period, an extra year (Year 7) is added to the period and the same formulas are followed to determine if any payout may be received in the following year.

The APA selling price is \$n, if the maximum Earnout and Earnup Amounts are received by Taxpayer. Taxpayer received the \$m closing payment in Year 1. The earnout period may extend an additional year; however, Taxpayer expects to receive the maximum Earnout Amount in Year 2 and Year 3.

At issue is the Earnup Amount, which is based on a multiple of historical EBT that is unlikely to be exceeded, but with some upside to the seller in the unlikely event future earnings are materially higher than expected. An analysis of Taxpayer’s current and historical revenues and profits, even with a continuation of recent growth trends, shows that Taxpayer is not likely to receive any portion of the Earnup Amount due to current economic conditions within the industry. Recent raw material price increases, which are a significant factor in the business’s net results, have not been successfully passed onto the end consumer. In addition, wage increases overseas have increased the business’s expenses more rapidly than it can increase its sales prices. Although the earnup period may extend an additional year, Taxpayer does not expect to receive any portion of the Earnup Amount.

The APA selling price will be reduced by \$p for purposes of § 453. This amount has been allocated to Corp 4 from the closing payment. The APA selling price will be further reduced by approximately \$r that was attributable to the sale of inventory, which is not included under the installment method. See § 453(b)(2)(B). The APA selling price will be increased by \$s of liabilities assumed by Buyer. Thus, Taxpayer represents that if

the maximum Earnout and Earnup Amounts are received the total selling price for purposes of § 453 will be approximately \$t.

Taxpayer represents that the total basis in the assets sold for purposes of § 453 is approximately \$u, which includes \$v of selling expenses and \$w of depreciation recapture.

Based on the foregoing, Taxpayer asserts that the normal basis recovery rule of § 15a.453-1(c)(2) would substantially and inappropriately defer recovery of its basis on the sale of the assets. Under the alternative method of basis recovery, Taxpayer will recover basis according to a gross profit ratio that considers the total anticipated sales price to be \$x rather than the stated maximum selling price of \$t.

RULING REQUESTED

Taxpayer requests a ruling allowing it to use an alternative method of basis recovery, as provided under § 15a.453-1(c)(7)(ii). Under its alternative method of basis recovery, Taxpayer proposes to allocate the same ratio of basis to each installment payment as that installment payment bears to the estimated amount of aggregate payments to be received by Taxpayer during the three years in which payments should be received. Because Taxpayer does not anticipate receiving any Earnup Amount, Taxpayer would proportionately allocate basis to Year 1, Year 2, and Year 3.

LAW AND ANALYSIS

Section 453(a) provides that, except as otherwise provided, income from an installment sale is taken into account under the installment method.

Section 453(b)(1) defines installment sale to mean a disposition of property where at least one payment is to be received after the end of the taxable year in which the disposition occurs.

Section 453(c) defines "installment method" as a method under which the income recognized for any taxable year from a disposition of property is that proportion of the payments received in that year which the gross profit (realized or to be realized when the payment is completed) bears to the total contract price.

Section 15a.453-1(c)(1) defines a "contingent payment sale" as a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs. Unless a taxpayer makes an election under § 15a.453-1(d)(3), contingent payment sales are to be reported on the installment method.

Section 15a.453-1(c)(2)(i)(A) provides that a contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the agreement, the

maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. Generally, the taxpayer's basis shall be allocated to payments received and to be received by treating the stated maximum selling price as the selling price for purposes of § 15a.453-1(b). If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule will apply.

Section 15a.453-1(c)(7)(i) generally provides that the normal basis recovery rules set forth in § 15a.453-1(c)(2) may, with respect to a particular contingent payment sale, substantially and inappropriately defer recovery of the taxpayer's basis.

Section 15a.453-1(c)(7)(ii) provides that the taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery.

Section 15a.453-1(c)(7)(ii) further provides that the taxpayer must file the request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits or the like. However, in special circumstances a reasonable projection may be acceptable based upon a specific event that has already occurred (e.g., corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

Taxpayer has represented that an analysis of the current and historical revenues and profits shows that Taxpayer is not likely to receive any portion of the Earnup Amount in Year 4, Year 5, Year 6 or Year 7 due to current economic conditions within the industry that include an increase in the cost of raw materials and an increase in overseas wages. Taxpayer has demonstrated, based on contemporaneous business conditions and revenue estimates that it does not expect to receive any portion of the Earnup Amount. Taxpayer proposes to ratably recover basis over the three-year installment period (Year 1, Year 2, and Year 3) and to use \$x as the total maximum selling price, which includes

a maximum Earnout Amount of \$m and excludes any Earnup Amount. Under this proposed method, Taxpayer will recover basis at a rate at least twice as fast as under the normal basis recovery rule.

CONCLUSION

In this case, based on the information submitted and representations made, it appears that Taxpayer will not receive any Earnup Amount. Accordingly, based on the information provided and each representation made, we conclude that Taxpayer's proposed alternative method of basis recovery (i) represents a reasonable method of basis recovery and (ii) will result in basis recovery at a rate twice as fast as the rate which basis would be recovered using the normal basis recovery rules. Accordingly, we conclude that Taxpayer may use its proposed alternative method of basis recovery for the sale of assets under the Asset Purchase Agreement, which are subject to installment method treatment under § 453.

Except as expressly provided in the preceding paragraph, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 your authorized representative.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)