

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact: \_\_\_\_\_, ID No. \_\_\_\_\_

Telephone Number: \_\_\_\_\_

Refer Reply To:  
CC:FIP:B03 – PLR-107819-14  
Date:  
August 27, 2014

**LEGEND:**

- Taxpayer =
- Parent =
- Acquiring =
- Target =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Effective Date =
- Adjustment Date 1 =
- Adjustment Date 2 =
- Adjustment Date 3 =
- Adjustment Date 4 =
- Adjustment Date 5 =

Payment Date 1	=
Payment Date 2	=
Payment Date 3	=
Payment Date 4	=
Payment Date 5	=
Percentage 1	=
Percentage 2	=
Percentage 3	=
Percentage 4	=
Percentage 5	=
Percentage 6	=
Dollar Amount 1	=
Dollar Amount 2	=
Dollar Amount 3	=
Dollar Amount 4	=
Contract Type 1	=
Retainee Type 1	=
Allocation Factor 1	=

Dear \_\_\_\_\_ :

This letter is in response to a letter from your authorized representative requesting a ruling on the proper test rate to use in determining the portions of the contingent payments pursuant to a merger agreement that are treated as payments of interest.

### **FACTS**

Effective on Effective Date and in accordance with a merger agreement (“Merger Agreement”), Acquiring merged with and into Target (“Merger”). Target was the surviving corporation in the Merger, and the separate existence of Acquiring ceased. Before the Merger, Acquiring was a wholly owned subsidiary of Taxpayer and an indirect subsidiary of Parent. Pursuant to the Merger Agreement, Target became a wholly owned subsidiary of Taxpayer. Parent, Taxpayer, and Target will be referred to collectively as “Group.”

Before the Merger, the members of Target (“Members”) held membership interests (“Membership Interests”) in Target. Taxpayer represents that the Membership Interests constituted equity interests in Target. Pursuant to the Merger Agreement, on Effective Date, the Membership Interests of Members who held a Contract Type 1 on Date 3 (“Record Date Members”) were cancelled and automatically converted into the right to receive consideration representing a portion of the purchase price described below.

Group agreed to pay a purchase price (“Purchase Price”) to the Record Date Members. The initial value of the Purchase Price (“Initial Purchase Price”) was Dollar Amount 2. Group paid a closing payment (“Closing Payment”) of Dollar Amount 1 to the Record Date Members on Date 4.

The Purchase Price is payable over five years. The Purchase Price will be adjusted upward or downward for reserve redundancies and deficiencies on each of five adjustment dates (“Adjustment Dates”), producing five adjusted purchase prices (“Adjusted Purchase Prices”). The Adjustment Dates are Adjustment Date 1, Adjustment Date 2, Adjustment Date 3, Adjustment Date 4, and Adjustment Date 5. On Adjustment Date 3, the Purchase Price will be adjusted downward for the decrease, if any, in the retention rate of Retainee Type 1 below Percentage 6, determined at Adjustment Date 3. Taxpayer estimates that the Purchase Price could range between Dollar Amount 3 and Dollar Amount 4, excluding interest.

Each Record Date Member will receive a portion of a percentage of each of the five Adjusted Purchase Prices annually on or before five corresponding payment dates

(“Payment Dates”). The Payment Dates are Payment Date 1, Payment Date 2, Payment Date 3, Payment Date 4, and Payment Date 5. Each of the percentages of the five Adjusted Purchase Prices will be allocated among the Record Date Members pro-rata on the basis of Allocation Factor 1 for the 5-year period beginning on Date 1 and ending on Date 2. The future payments scheduled to be made on or before any of the Payment Dates will be referred to as “Future Payments.” If one of the Future Payment amounts described above is negative (because of the reduction by previous payments), then no payment will be made on the corresponding Payment Date, but the Record Date Members will not be obligated to return any amounts previously paid to them.

The five Adjusted Purchase Prices will be paid to the Record Date Members, in the aggregate, according to the following schedule:

Date 4: The Closing Payment.

On or before Payment Date 1: Percentage 1 of the first Adjusted Purchase Price (determined as of Adjustment Date 1) less the Closing Payment.

On or before Payment Date 2: Percentage 2 of the second Adjusted Purchase Price (determined as of Adjustment Date 2) less previous payments.

On or before Payment Date 3: Percentage 3 of the third Adjusted Purchase Price (determined as of Adjustment Date 3) less previous payments.

On or before Payment Date 4: Percentage 4 of the fourth Adjusted Purchase Price (determined as of Adjustment Date 4) less previous payments.

On or before Payment Date 5: Percentage 5 of the fifth Adjusted Purchase Price (determined as of Adjustment Date 5) less previous payments, plus interest (to the extent computed and payable).

Simple interest (“Interest”) will be computed on Adjustment Date 5 as if it had accrued on the five unpaid balances of the final Adjusted Purchase Price determined immediately before the five Future Payments. The Interest will be computed as if it accrued over five computation periods, the first running from Effective Date until Payment Date 1, and the other four running from each of the first four Payment Dates until the next Payment Date. For example, the unpaid balance of the final Adjusted Purchase Price for the first computation period will be the final Adjusted Purchase Price reduced by the Closing Payment, and the unpaid balance for the second computation period will be the final Adjusted Purchase Price reduced by the Closing Payment and the first Future Payment. The Interest will be computed as if it accrued at five variable rates (“Annual Rates”), one for each computation period, with each rate equal to the

10-year United States Treasury bond rate as of the corresponding Adjustment Date plus one percent (1%) per annum. The Interest will be paid in a balloon payment as part of the fifth Future Payment on or before Payment Date 5. However, if, based on the fifth Future Payment computation, a Record Date Member has already received more than the portion of the final Adjusted Purchase Price to which the Record Date Member is entitled, Interest due will be offset against the overpayment of principal. In other words, the Interest paid to a Record Date Member will be reduced (possibly to zero) and not paid as part of the fifth Future Payment if the Closing Payment and the first four Future Payments together are greater than the fifth Adjusted Purchase Price.

Taxpayer represents that the Future Payments and Interest are contingent payments as defined under § 1.483-4(a) of the Income Tax Regulations, and the contingencies are not remote as defined under § 1.1275-2(h)(2).

Taxpayer represents that the Merger Agreement is a contract for the sale of property, and that all of the payments to the Record Date Members except for the Closing Payment are deferred until more than six months after Effective Date, the effective date of the Merger.

## **LAW**

Section 483 of the Internal Revenue Code provides that, in the case of any payment under any contract for the sale or exchange of property to which § 483 applies, there shall be treated as interest that portion of the total unstated interest under the contract which, as determined in a manner consistent with the method of computing interest under § 1272(a), is properly allocable to such payment.

Section 1.483-1(a)(1) provides that § 483 generally applies to a contract for the sale or exchange of property if the contract provides for one or more payments due more than one year after the date of the sale or exchange, and the contract does not provide for adequate stated interest. In general, a contract has adequate stated interest if the contract provides for a stated rate of interest that is at least equal to the test rate (determined under § 1.483-3) and the interest is paid or compounded at least annually. Section 483 may apply to a contract whether the contract is express (written or oral) or implied. For purposes of § 483, a sale or exchange is any transaction treated as a sale or exchange for tax purposes.

Section 1.483-1(a)(2)(i) provides that, if § 483 applies to a contract, unstated interest under the contract is treated as interest for tax purposes. Thus, for example, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange.

Section 1.483-1(a)(2)(ii) provides that any stated or unstated interest on a contract subject to § 483 is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). See §§ 1.446-1, 1.451-1, and 1.461-1. For purposes of the preceding sentence, the amount of interest (including unstated interest) allocable to a payment under a contract to which § 483 applies is determined under § 1.446-2(e).

Section 1.483-3(a) provides that, for purposes of § 483, the test rate of interest for a contract is generally the same as the test rate that would apply under § 1.1274-4 if the contract were a debt instrument.

Section 1.483-4(a) provides that § 1.483-4 applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to § 483. Section 1.483-4 applies even if the contract provides for adequate stated interest under § 1.483-2. (Section 1.483-2 provides that a contract generally provides for adequate stated interest if the sum of the deferred payments does not exceed the sum of the present values of the deferred payments and the present values of any stated interest payments due under the contract.) If § 1.483-4 applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275-4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in § 1.1275-4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275-4(c)(4). However, any interest, or amount treated as interest, on a contract subject to § 1.483-4 is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

Section 1.1275-4(c)(4)(i) provides that, except as provided in § 1.1275-4(c)(4)(iii) (relating to fixed but deferred payments), the portion of a contingent payment treated as interest under § 1.1275-4(c)(4)(ii) is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

Section 1.1275-4(c)(4)(ii)(A) provides that a contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

Section 1.1275-4(c)(4)(ii)(B) provides that the test rate used for purposes of § 1.1275-4(c)(4)(ii)(A) is the rate that would be the test rate for the overall debt instrument under § 1.1274-4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

### **ANALYSIS**

Section 1.483-4 applies to the Merger Agreement because the Merger Agreement is a contract for the sale or exchange of property (the overall contract), the Merger Agreement provides for one or more contingent payments, and the Merger Agreement is subject to § 483. See § 1.483-4(a). Section 1.483-4 applies to the Merger Agreement even if it provides for adequate stated interest under § 1.483-2. Therefore, interest under the Merger Agreement is generally computed and accounted for using rules similar to those that would apply if the Merger Agreement were a debt instrument subject to § 1.1275-4(c). Accordingly, each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275-4(c)(4). See § 1.483-4(a). Section 1274 does not apply to the Merger Agreement because all of the deferred payments are contingent. See, for example, § 1.483-4(b), Example 2.

A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest. See § 1.1275-4(c)(4)(ii)(A).

The test rate used for purposes of § 1.1275-4(c)(4)(ii)(A) is the rate that would be the test rate for the overall debt instrument under § 1.1274-4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made (“§ 1.1274-4 test rate”). See § 1.1275-4(c)(4)(ii)(B). However, § 1.1275-4(c)(4)(ii)(B) also provides that, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the § 1.1274-4 test rate, the test rate is the stated interest rate.

The first four Future Payments are not accompanied by payments of stated interest. Therefore, the test rate for each of the first four Future Payments is the § 1.1274-4 test rate.

If there is a fifth Future Payment (not including Interest), five portions of Interest were computed as if they accrued on the fifth Future Payment in the five Computation Periods. Therefore, the fifth Future Payment (not including Interest) is accompanied by those five portions of Interest. The fifth Future Payment (not including Interest) and the five portions of Interest determine an implicit interest rate using annual compounding. If the implicit interest rate exceeds the § 1.1274-4 test rate, the test rate for the fifth Future Payment (not including Interest) and the five portions of Interest is the implicit interest rate. Otherwise, the test rate is the § 1.1274-4 test rate. The Interest other than the five portions of Interest accompanying the fifth Future Payment does not accompany any payment of stated principal. Therefore, the test rate for that Interest is the § 1.1274-4 test rate.

If there is no fifth Future Payment (not including Interest), the Interest remaining after reduction by the excess of the first four Future Payments over the final Adjusted Purchase Price does not accompany any payment of stated principal. Therefore, the test rate for that Interest is the § 1.1274-4 test rate.

### **RULINGS**

Based on the information submitted and representations made, we rule that the proper test rate to use in determining the portion of each contingent payment pursuant to the Merger Agreement that is treated as a payment of interest is the test rate specified in the ANALYSIS section of this letter for that payment.

This ruling is limited to the issue of the proper test rate for the contingent payments made pursuant to the Merger Agreement. This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. 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. In particular, no opinion is expressed concerning whether the Merger Agreement is a contract for the sale or exchange of property for purposes of § 483.

The ruling contained in this letter is 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.

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 representatives.

Sincerely,

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William E. Blanchard  
Special Counsel  
Office of the Associate Chief Counsel  
(Financial Institutions & Products)