

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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TY:
Taxpayer:
Year 1:
Year 2:
Year 3:
Year 4:
Company A:
Company B:
e%:
\$f:
\$g:
\$h:
\$i:
\$j:
\$k:
\$l:
\$m:
\$n:
\$o:
\$p:

Dear :

This is in reply to the 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), the Taxpayer filed its ruling request prior to the due date (including extensions) of its Year 1 tax return.

FACTS

The Taxpayer uses a cash basis method of accounting and a calendar tax year. He is the beneficial owner of approximately e% of Company A, an S corporation, on a fully-diluted basis after considering fully vested option holders of the company. In Year 1, Company A entered into a merger with Company B, a publically-traded corporation, whereby Company A would become the wholly-owned indirect subsidiary of Company B. Consideration, in the form of cash and Company B shares, was paid to Company A shareholders in an initial amount of \$f payable in Year 1, and then three deferred payments payable on the successive anniversaries of the merger closing in Year 2, Year 3, and Year 4.

The deferred payments are each an amount equal to \$g multiplied by a fraction with a numerator equal to the average of the closing market prices of Company B shares over the previous five trading days and a denominator equal to \$h, the approximate share price of Company B at the time of the merger. The first deferred payment also included adjustments consisting of certain post-merger true-ups.

By the time of the first deferred payment, in Year 2, share prices for Company B had declined to \$i. Based on this share price, the first deferred payment was \$j. The Taxpayer estimates that its share of the deferred payments, after accounting for remaining transaction costs, will be:

	Year 2	Year 3	Year 4
\$k		\$l	\$m

In total, the Taxpayer estimates, based on the Year 2 share price, that Taxpayer's share of the purchase price it will receive in exchange for Taxpayer's ownership interest in Company A will be \$m. Further, Taxpayer's tax basis in its ownership interest at the time of sale was \$n.

The Taxpayer requests a ruling that it be permitted to use an alternative method of basis recovery (as described below) under § 15A.453-1(c)(7)(ii) to report payments from the contingent payment sale of Taxpayer's ownership interest in Company A to Company B because the normal basis recovery rule set forth in § 15A.453-1(c)(3)(i) will substantially and inappropriately defer recovery of basis based on Company B's share price. Pursuant to § 15A.453-1(c)(7)(ii), Taxpayer asserts that its proposed alternative method of basis recovery is a reasonable method of ratably recovering basis, and that over time Taxpayer likely will recover basis at a rate at least twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule.

LAW AND ANALYSIS

Section 453(a) of the Code provides as a general rule that income from an installment sale shall be taken into account under the installment method for federal income tax

purposes. 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 close of the taxable year in which the disposition occurs. The term “installment method” is defined in section 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 which the gross profit (realized or to be realized when the payment is completed) bears to the total contract price.

Section 453(j)(2) provides that the Secretary of the Treasury shall prescribe regulations providing for ratable basis recovery in transaction where the gross profit or the total contract price (or both) cannot be readily ascertained.

Section 15A.453-1(c)(1) of the Temporary Income Tax Regulations 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 maximum selling price if, under the terms of the agreement, the maximum amount of sales 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.

The Taxpayer has made an installment sale for a fixed period but for a contingent sales price. Accordingly, Taxpayer is subject to the rules of § 15A.453-1(c)(3)(i). That section provides generally that when a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer’s basis shall be allocated to the taxable years in which payments are to be received in equal annual increments.

Additionally, § 15A.453-1(c)(3)(i) provides generally that if in any taxable year no payment is received or the payment received is less than the basis allocated to that year, no loss shall be allowed unless the taxable year is the final payment year under the agreement. When no loss is allowed, the unrecovered portion of basis allocated to the taxable year is carried forward to the next succeeding taxable year.

Section 15A.453-1(c)(3)(i) further provides that a special rule under section 15A.453-1(c)(7) will apply if application of the foregoing general rules would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis in a particular case.

Section 15A.453-1(c)(7)(i) provides that the normal basis recovery rules set forth in § 15A.453-1(c)(3) 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 recover 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.

Based on share prices in Year 2, the Taxpayer expects to receive the following payments in the years noted below:

	Year 1	Year 2	Year 3	Year 4
\$o		\$k	\$l	\$l

Pursuant to § 15A.453-1(c)(3)(i), when a stated maximum selling price cannot be determined as of the close of the taxable year in which a sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sales price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. Because in this case the stated

maximum selling price was not determinable as of the close of Year 1, but the maximum period over which the payments may be received under the contingent purchase agreement is fixed (i.e., 4 years), under the normal basis recovery rule, the Taxpayer's basis should be allocated to the taxable years in which payment may be received under the purchase agreement in equal annual increments. The application of this rule, assuming no change in Company B's stock price from Year 2, is illustrated in Scenario 1 below:

	Year 1	Year 2	Year 3	Year 4
Beginning Basis				

Note, in Year 4, the amount of deferred basis would be \$p, which would be recognized as a loss.

As is demonstrated in Scenario 1 above, application of the normal basis recovery rule set forth in § 15A.453-1(c)(3)(i), assuming no change in Company B's stock price, would substantially and inappropriately defer recovery of basis based on immediate past relevant share prices resulting in a disproportionately large gain in Year 1 and a disproportionately large loss in Year 4.

Pursuant to § 15A.453-1(c)(7)(ii), the Taxpayer may use an alternative method of basis recovery if the Taxpayer can show that (A) the alternative method is a reasonable method of ratably recovering basis, and (B) under the alternative 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.

Under the Taxpayer's proposed alternative method, the Taxpayer will allocate the ratio of basis to each installment payment as that installment payment bears to the estimated amount of aggregate payments to be received by the Taxpayer during the 4-year term of the installment obligation. Based on the Year 2 stock price, the basis recovery would be as reflected in Scenario 2, below:

Scenario 2 - Alternative Basis Recovery

	Year 1	Year 2	Year 3	Year 4
Beginning Basis				

As illustrated above, the Taxpayer’s proposed alternative basis recovery method is a reasonable method of ratably recovering basis, and the Taxpayer will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the normal basis recovery rule. Based on the information provided by the Taxpayer, the proposed alternative basis recovery methodology thus satisfies the requirements of § 15A.453-1(c)(7)(ii).

CONCLUSION

Based on the information provided and the representations made, we conclude that the Taxpayer’s proposed alternative basis recovery method is a reasonable method of ratably recovering basis, and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate more than twice as fast as the rate at which basis would be recovered under the normal basis recovery rules. Accordingly, the Taxpayer’s use of the proposed alternative method of basis recovery is approved.

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) 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.

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.

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.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
(Income Tax & Accounting)

cc: