

Internal Revenue Service

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Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:IT&A:5-PLR-122560-98

Date: SEP 13 1999

Legend:

19xx =
\$x =
\$y =
TP1 =
TP1W =
TP2 =
Affiliate =
Agency =
Agreement =
Deficiency =

Monthly Recovery =
Named Parties =

Purchaser =

Related Entities =

Dear

This is in response to your authorized representative's request, on your behalf, for a private letter ruling under section 453 of the Internal Revenue Code and 15a.453-1(c)(7)(ii) of the temporary income tax regulations thereunder. Section 15a.453-1(c)(7)(ii) provides for use of an alternative method of basis recovery in circumstances involving contingent payment installment sales of property where use of the general rules provided in the Code and regulations would inappropriately defer recovery of a taxpayer's basis in the property sold.

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FACTS:

TP1 and TP1W are cash basis taxpayers. TP1 and TP2 are brothers who owned and operated an insurance agency under the name Agency. TP1 owned a majority interest in the Agency. More than 15 years prior to 19xx, TP1 purchased his interest in the business conducted by the Agency for \$y. TP2 held a minority interest in the Agency. The information provided does not indicate whether TP2 purchased a portion of TP1's interest in the business or acquired his interest by some other means. During 19xx, Purchaser made an offer to TP1 and TP2 to purchase the assets used in the Agency's insurance business. It has been represented that the contracts which TP1 and TP2 executed with the Purchaser were identical in all respects other than the sales price, which reflected the value the respective interests in the Agency owned by TP1 and TP2. The provisions of TP1's sales contract (the "Agreement") are described as the request for a ruling is limited to TP1.

The Agreement indicates that TP1 and TP2 simultaneously signed identical asset purchase agreements (except for the amount of the purchase price) for the purpose of selling 100 percent of the Business to the Purchaser. The Agreement defines the "Business" as the Agency. Section 1.01 of the Agreement provides that TP1 and TP2, who are sometimes collectively referred to as "Sellers" and individually as a "Seller," sold all of their right, title, and interest in the "Business Assets" to the Purchaser.

Section 1.01 of the Agreement defines the term "Business Assets" as any and all assets for use in the Agency which are described as: (a) The receivables due from customers of the Agency related to payments owed to insurance companies for premiums, interest, service charges, and similar obligations due said insurance companies from customers, as listed on Schedule 1.01(a) of the Agreement, as well as contingent income, subject to the terms of section 5.02(b) of the Agreement; (b) All of the Agency, and the lists of clients and suppliers (including as set forth on Schedule 1.01(b)(i) of the Agreement), goodwill and other intangible assets, including without limitation, all of Seller's intellectual or similar property relating to the Business, including, without limitation, its trade names, and applications therefor, listed on Schedule 1.01(b)(ii) of the Agreement, and the exclusive right to use the name Agency and any other fictitious names of the Business and all variations thereof; (c) All of the Sellers' permits, licenses, orders, or other approvals utilized in the operation of the Agency that are assignable to the Purchaser; (d) All of the Sellers' and the Agency's agreements relating to the Agency as described on schedule 1.01(d) of the Agreement; and (e) All of Sellers' books, records, documents, books of account, files and correspondence insofar as same relate to the operation of the Agency.

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Section 5.02 of the Agreement provides, in part, that all contingent income paid after the Closing Date from insurance companies to the Purchaser, based on the level of revenue generated by the Agency for the insurance company during a certain period of time, would be pro rated according to the number of days in that aforesaid period of time prior to the Closing Date (which would be paid to TP1 and TP2) and the number of days in that aforesaid period of time after the Closing Date (which would be paid to the Purchaser).

Section 1.02 of the Agreement provides that the term "Business Assets" shall include only the assets listed in section 1.01 and the Schedules thereto, and shall not include: (i) any of Sellers' cash and cash equivalents, (ii) commissions received by the Sellers or Purchaser directly related to fully completed insurance applications sent to insurance companies prior to the Closing Date, including but not limited to insurance applications for Spring 19xx multi-peril and hail crop insurance (Pre-Closing Commissions) which were to be paid to Sellers upon receipt by the Purchaser, or (iii) any real property or improvements thereon.

Section 2.01 of the Agreement provides that the aggregate consideration payable to TP1 shall be an amount equal to fifty percent of the collected commission income during the five consecutive years from the closing date provided, however, that the price would not be less than \$x. For purposes of the provision, the term "collected commission income" was defined as commissions, other than Pre-Closing commissions and commissions from "Bank Business" (insurance products placed through the Purchaser insuring risks borne by the Affiliate (or its successors), Related Entities, Named Parties, and customers of the Affiliate) collected by the Purchaser after the closing date.

Irrespective of section 2.01 of the Agreement, your authorized representative has indicated that both TP1 and the Purchaser interpret "Bank Business" to include all commissions other than Pre-Closing commissions and commissions or service fees on insurance products sold by TP1 or TP2 subsequent to the closing of the sale. It has similarly been represented that contrary to sections 1.01(a) and 3.01 of the Agreement, no accounts receivable or liabilities were transferred to, or assumed by, the Purchaser. The provisions in the Agreement were attributed to use of a standard sales contract.

At the closing of the sale, the Purchaser made a \$x advance payment of the amount of the minimum purchase price provided for in the Agreement. Within 15 days after the end of each of the 60 consecutive months subsequent to the closing, the Purchaser was required to pay Sellers additional amounts equal to the difference between (i) 50 percent of the collected commission income for such calendar month, and (ii) the sum of the Monthly Recovery and any Deficiency. The amount indicated as the Monthly Recovery was greater than the amount required to provide for pro rata recovery of the advance payment of the minimum sales price over the 60 month term of the Agreement.

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Law and Analysis:

Section 453(a) of the Code provides as a general rule that, except as otherwise provided in that section, income from an installment sale shall be taken into account under the installment method for federal income tax purposes.

Section 453(b)(1) of the Code defines the term "installment sale" as a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453(c) of the Code defines "installment method" 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 payment is completed) bears to the total contract price.

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

Section 15a.453-1(b)(2)(iii) of the temporary regulations provides that the term "contract price" means the total contract price equal to the selling price reduced by that portion of any qualifying indebtedness (as defined in section 15a.453-1(b)(2)(iv)), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property, adjusted to reflect commissions and other selling expenses.

Section 15a.453-1(b)(2)(v) of the temporary regulations defines the term "gross profit" as the selling price less the adjusted basis as defined in section 1011 of the Code and the regulations thereunder.

Section 15a.453-1(c)(1) of the temporary regulations defines the term "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 the sale or other disposition occurs. The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transaction, regardless of the existence of a stated maximum selling price or fixed payment terms.

The temporary regulations provide rules for allocating the taxpayer's basis to payments received and to be received in a contingent payment sale. The rules distinguish between contingent payment sales for which a maximum selling price is

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determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable.

Section 15a.453-1(c)(2)(i)(A) of the temporary regulations 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 sales proceeds that may be received by the taxpayer can be determined at the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement.

Section 15a.453-1(c)(3)(i) of the temporary regulations provides 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 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.

Section 15a.453-1(c)(7)(ii) of the temporary regulations provides that a 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:

(1) that the alternative method is a reasonable method of ratably recovering basis; and

(2) 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.

In addition, section 15a.453-1(c)(7)(ii) of the temporary regulations provides guidelines as to what type of data is acceptable in demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis. The section provides that the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profits, or other factual data that are subject to verification. The section further provides that the taxpayer ordinarily is not permitted to rely upon projections of future productivity,

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receipts, profits, or the like. However, in special circumstances a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred.

Under the method of basis recovery proposed by TP1, the amount of basis allocated to an installment payment would bear the same ratio to TP1's total basis in the property sold that the principal component of the installment payment, determined in accordance with the provisions of section 1274 of the Code and regulations thereunder, would bear to the estimated total principal payments that TP1 would receive under the terms of the Agreement. The amount of the total estimated installment payments to be received would be determined by the use of an arithmetic formula based on the production of commission income by TP1 and TP2, the historical growth rate in such income, and certain additional factors and/or modifications.

Conclusion:

Based on the information submitted and the representations made, we conclude that application of the normal basis recovery rule of section 15a.453-1(c)(3) would substantially and inappropriately defer recovery of TP1's basis and that TP1's alternative method of basis recovery is reasonable. Accordingly, the principal portion of each installment payment that TP1 receives under the terms of the Agreement that will be treated as basis recovery will bear the same ratio to his total basis in the property sold as the principal payment bears to the total amount of the principal payments estimated to be received under the Agreement.

The above ruling is conditioned on the representations that TP1's basis in the assets sold was \$y at the time of sale and that the assets sold did not include accounts receivable or rights to accounts receivable. In addition, it is conditioned on the amounts to be received by TP1 under his employment contract with Purchaser being reasonable compensation for the services TP1 will provide.

Except as expressly provide herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.

This ruling is directed only to the taxpayer(s) to whom it is addressed. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this letter to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Income Tax and Accounting)

By: 

Douglas A. Fahey
Assistant to the Branch Chief, CC:DOM:IT&A:5

Enclosures (2)

cc:

cc:

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