

**Internal Revenue Service**

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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:B05  
PLR-136750-05  
Date:  
October 07, 2005

Legend:

Buyer

Company

Date 1

Date 2

Date 3

SH1

SH2

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s

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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 section 15a.453-1(c)(7)(ii) of the Temporary Income Tax Regulations. 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.

#### FACTS:

SH1 and SH2 (the "Shareholders") owned r and s percent, respectively, of the stock of the Company, an S corporation as defined in section 1361(a) of the Internal Revenue Code. On Date 1, all of the stock of the Company was sold to Buyer. The Shareholders and the Buyer made elections under section 338(h)(10) to have the sale of the Company stock treated as a deemed sale of the assets and business of the Company, subject to certain liabilities, to Buyer followed by the liquidation of the Company.

The Stock Purchase Agreement ("Agreement") provided for a payment of \$t in the year of sale and payments of \$u on each of the first two anniversaries of Date 1. In addition, the Agreement provided that within a specified number of days after the end of each calendar year end between Date 2 and Date 3, the Buyer would pay the Shareholders an amount equal to v percent of the annual operating income (as defined in the Agreement) of the Company in excess of \$w. The Agreement placed no maximum on the amount of the contingent payments.

#### 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(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 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)(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) 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 rules will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rules 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 rules 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, 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.

In circumstances involving the sale of all of the stock of an S corporation in a transaction which is the subject of section 338(h)(10) elections by the S corporation's shareholders and the purchaser of the stock, the shareholders are treated as if the cash, the issue price of qualifying installment obligations, and the fair market value of any other property received for their S corporation stock were received on a deemed sale of the S corporation's assets and such amounts or property were then distributed by the S corporation and received by the shareholders as the selling price of their stock in the liquidating corporation. A "qualifying obligation" is an obligation received on the sale or exchange of corporate assets by a liquidating corporation during the 12-month period beginning on the date the plan of liquidation is adopted.

In the subject circumstances, the shareholders have requested that they be allowed to use an alternative method of basis recovery to report payments received on the qualifying installment obligation of the Buyer which they are treated as having received from the Company as a liquidating distribution for their stock in the Company.

Under the method of basis recovery proposed by the Shareholders, the amount of basis allocated to an installment payment would bear the same ratio to the total basis in such Shareholder's stock of the Company that the installment payment bears to the estimated amount of the aggregate payments to be received by such Shareholder for her stock in the Company. The payments to be received during the term of the installment obligation were estimated on the basis of the recent rate of return earned by the parent company of the Buyer on the carrying value of its investments in businesses it owns as well as the Company's earnings history, its business, and the business cycle.

#### 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 a Shareholder's basis and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate at least twice as fast as the rate at which basis would be recovered under the normal basis recovery rules. The proposed alternative method of basis recovery represents a reasonable method of basis recovery. Accordingly, the use of the proposed alternative method of basis recovery by each of the Shareholders is approved.

#### CAVEATS:

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. A copy of the letter is enclosed. Also enclosed is a copy of the ruling letter

with the deletions proposed to be made when the letter is subject to disclosure under section 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) 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,

Roy A. Hirschhorn  
Assistant Branch Chief, Branch 5  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure

Copy of this letter

Copy of letter with proposed deletions