

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

In Re:

Refer Reply To:

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Date:

December 31, 2003

LEGEND:

Taxable years 1 through 7 =

Taxpayer =

State A =

Members =

X =

Y =

Location B =

S =

Date 1 =

Date 2 =

Buyer =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

Dear :

This is in reply to your request for a ruling dated October 14, 2002, to allow the members of Taxpayer to use an alternative method of basis recovery under § 15a.453-1(c)(7)(ii) of the Temporary Income Tax Regulations to report contingent payments for taxable years 1 through 7. The ruling is requested because you believe the normal basis recovery rule will substantially and inappropriately defer recovery of basis.

FACTS:

Taxpayer, a State A limited liability company, was formed on Date 1 by the four individual Members, who collectively own 100 percent of Taxpayer. Taxpayer uses the accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. Taxpayer designed, engineered, and manufactured x used in y.

Taxpayer's headquarters are in State A; it also owned an assembly and test facility in Location B, operated by its 100 percent subsidiary, S.

On Date 2, Buyer purchased substantially all the assets of Taxpayer and S. The purchase price included a payment of cash by Buyer and an assumption by Buyer of Taxpayer and S's liabilities. All the hard assets were sold at their adjusted book value, with the amount being paid for each asset thus being equal to that asset's adjusted basis. Because Taxpayer realized no gain on the sale of the hard assets, Taxpayer had no depreciation recapture with respect to those assets. However, Taxpayer did realize a long term capital gain on the sale of its goodwill and other intangible assets (of a type described in § 197 of the Internal Revenue Code). The amount paid for goodwill was based on an independent appraisal prepared by a national accounting firm.

The asset purchase agreement, or contract, between Taxpayer and Buyer provided that the purchase price (or total sales price) for Taxpayer's assets consisted of (i) the cash purchase price (subject to adjustment), (ii) Buyer's assumption of liabilities at the closing, and (iii) the deferred purchase price. The adjustments to the cash purchase price consist of holdback funds (held in escrow to secure the post-closing obligations of Taxpayer) and of a purchase price adjustment (reflecting a dollar-for-dollar increase or decrease in the price based on certain balance sheet adjustments).

The deferred purchase price component of the purchase price consists of an earnout provision, under which Buyer is obligated to pay the Taxpayer a specified percentage of net sales in excess of the annual baseline net sales of certain products and technologies. The obligation is for a fixed period: it lasts for 5 calendar years after the closing, although the actual earnout payments (if any) are to be received in each subsequent year. (Stated differently, the Buyer must calculate its net sales for taxable years 2 through 6, with any required earnout payments being made in taxable years 3 through 7.) Thus, the exact amount to be received by Taxpayer under the earnout provision is contingent on future sales.

Taxpayer computed a total sales price of \$f on its Year 1 partnership income tax return. Taxpayer based its estimate of the aggregate payments to be received during the term of the installment obligation on historical data and earning trends. Taxpayer's computation and related projections are summarized below:

<u>Description</u>	<u>Taxable year received</u>	<u>Amount</u>	<u>Percentage of total sales price</u>
Cash received at closing (including liability relief)	Year <u>1</u>	\$ <u>a</u>	

Cash received under the purchase price adjustment	Year <u>2</u>	\$ <u>b</u>	
Estimated cash to be received under the holdback provision	Year <u>3</u>	\$ <u>c</u>	
Estimated cash to be received under the earnout provision	Years <u>3</u> - <u>5</u> Year <u>6</u> Year <u>7</u>	Zero \$ <u>d</u> \$ <u>e</u>	
<u>Total Sales Price</u>		\$ <u>f</u>	<u>100 percent</u>

Taxpayer submitted its private letter ruling request before the date, including extensions, that its return for Year 1 was due.

RULING REQUESTED:

Taxpayer submits that the normal basis recovery rules of § 15A.453-1(c)(3), (4), and (5) will substantially and inappropriately defer recovery of basis and will result in a substantial distortion of Taxpayer's income. Accordingly, Taxpayer requests a ruling that it be permitted to use an alternative method of basis recovery, as provided under § 15A.453-1(c)(7)(ii). 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 7-year term of the installment obligation.

LAW AND ANALYSIS:

Section 453(a) provides that income from an installment sale shall be taken into account under the installment method. 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 end of the taxable year in which the disposition occurs. The term "installment method" is defined in § 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 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.

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 § 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.

A pro rata basis recovery over a 7-year period would result in _____ percent of basis being recovered in one year. A recovery at twice the above rate would result in a _____ percent basis recovery in a single year.

Taxpayer's representations demonstrate that it will receive _____ percent of the total sales price ($\$a$ divided by $\$f$) in Year 1. Taxpayer's representations also demonstrate that if it is required to recover basis ratably, it will sustain a very sizeable long term capital loss (approximately $\$g$) in the final year of the installment period.

Based on the information provided and the representations made, we conclude that Taxpayer's 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. The proposed alternative method of basis recovery represents a reasonable method of basis recovery. Accordingly, Taxpayer's use of the proposed alternative method of basis recovery is approved.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)

CC: