

Office of Chief Counsel
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Memorandum

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date: December 03, 2007

to: Revenue Agent
LMSB Examination Team

from: Marjory A. Gilbert, Senior Counsel
Large and Mid-Size Business Division (RFPH)

subject: Taxation of Purported Contingent Payment Sale
Corp F

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corp A	=
Corp B	=
Corp C	=
Corp D	=
Corp E	=
Corp F	=
Owner 1	=
Owner 2	=
Owner 3	=
Entity G	=
Entity H	=
Entity J	=
Entity K	=
Entity M	=

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Industry N =

Asset Purchase =

Agreement

Note Agreement =

Non-Recourse =

Contingent Payment

Term Note

Non-Recourse =

Contingent Payment

Working Capital Note

Profits =

Mirror =

P =

Q =

R =

S =

T =

W =

X =

Y =

Z =

AA =

BB =

CC =

DD =

EE =

FF =

GG =

HH =

JJ =

KK =

MM =

NN =

POSTF-134629-07

PP	=
QQ	=
RR	=
SS	=
WW	=
XX	=
YY	=
ZZ	=
AAA	=
BBB	=
CCC	=
DDD	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 14	=
Year 15	=

All numerical amounts, section numbers and dates without a specific legend equivalent are replaced with "***".

ISSUES

1. Whether the Year 10 transaction at issue constitutes a sale of assets for tax purposes.
2. Whether the non-recourse contingent payment notes from the Year 10 transaction constitute debt instruments.
3. Alternatively, if the Year 10 transaction is a contingent payment asset sale for tax purposes:
 - A. Whether the regulations promulgated pursuant to I.R.C. §§ 338 and 1060 modify the application of Temp. Treas. Reg. § 15A.453-1(c) to allow all basis to be recovered before recognition of any gain, as in open transaction reporting, by treating the sale as divisible into seven separate sales for each

class of property, i.e. Classes I through VII, taxed serially in class order with different gross profit ratios.

- B. Whether I.R.C. §§ 453A and 483 apply and, if so, how said sections should be applied.
4. Whether I.R.C. § 481 applies to tax all previously deferred income from the use of the installment method in the year under examination.

CONCLUSIONS

1. The Year 10 transaction, in substance, is not a sale for tax purposes.
2. The non-recourse contingent payment notes do not constitute debt instruments.
3. Alternatively, if the form of the Year 10 transaction is respected:
 - A. The regulations promulgated pursuant to Sections 338 and 1060 do not modify the installment method of accounting to allow the equivalent of open transaction reporting.
 - B. The form of the transaction is a contingent payment asset sale for which the maximum selling price is determinable and both §§ 383 and 453A apply, as addressed below.
4. Section 481 applies to tax the previously deferred income in the year under examination, as addressed below.

FACTS

A. Summary

Most of the assets the subject of the Year 10 transaction were originally owned by Owner 1 , Owner 2 , and Owner 3 via a S corporation. Owners 1 through 3 sold ** percent of their stock in the S corporation to a third party for approximately \$ **, with an I.R.C. § 338(h)(10) election. In ** years the corporation was in bankruptcy, with suspended lawsuits among and between the third party purchaser, Owners 1 through 3, and others. There were allegations of accounting fraud, among other allegations.

Owners 1 through 3 reacquired their assets (and other assets that had been purchased by the corporation) in a bankruptcy liquidation auction. Owners 1 through 3 contributed the auction-acquired assets to Corp F, a newly formed S Corporation. The assets were old X, W, inventory, some contracts and de minimus tangible personal

property. The assets were used in Corp F's business for ** months then, except for the W, "sold" to a new non-profit entity, allegedly to avail of the Z.

The sale was cast, in form, as a contingent payment asset sale with the non-profit executing a \$ DD Non-Recourse Contingent Payment Term Note (sometimes referred to as "Term Note" because it terminated in P years) and a \$ CC Non-Recourse Contingent Payment Working Capital Note. The new non-profit had no assets prior to the "purchase" of the assets.

Pursuant to the terms of the Asset Purchase Agreement, Note Agreement, and other agreements, the new non-profit was:

- (1) subject to a confidentiality agreement;
- (2) required to pay annual salaries to Owners 1 through 3 for the life of the Term Note;
- (3) required to allow Owner 2 or 3 to run the business;
- (4) required to hire Corp F's employees to operate the business day-to-day;
- (5) required to enter into a security agreement covering all of the non-profit assets (both from the "sale" and after acquired assets);
- (6) required to pay all "Profit" to Owners 1 through 3 as Term Note payments less a ** percent share for the non-profit, with the non-profit relieved of any obligation to pay Corp F except from the "Profit";
- (7) required to "syndicate" the Non-Recourse Contingent Payment Term Note for up to ** holders, retaining certificates of note ownership;
- (8) required to enter into another non-recourse contingent payment note with Corp F for \$ CC Working Capital to run the business using the assets;
- (9) prohibited from entering into any other business; and
- (10) prohibited from selling the assets.

After 1 year, the \$ CC Non-Recourse Contingent Payment Working Capital Note terminates and, after P years, all liabilities for payments under the \$ DD Non-Recourse Contingent Payment Term Note are extinguished; but, it is not clear who will retain the "sold" assets.¹ If the non-profit breaches any of the 10 terms summarized above, it is in default and subject to various "penalties," as addressed below.

¹ The non-profit and the principals should be the subject of a referral to the exempt organization division to consider (1) whether the non-profit is organized and operated for a tax exempt purpose and not for the substantial private benefit of individuals; (2) whether the Corp F principals with a high salary and positions at the non-profit are subject to excise taxes for excess benefit transactions under I.R.C. § 4958 as

B. Year 4-Year 9

In Year 4, Owner 1 formed Corp A Industry N. Corp A was one of the first successful Industry N companies, spawning a host of affiliated and competitive businesses. Some other businesses initially formed by Owner 1 were Corp B and Corp C, both Industry N companies.

Eventually, a separate S Corporation, Corp D, was formed to hold the Corp A business, among other related businesses. Thereafter, about the time Owner 1 wanted to retire, attorneys Owner 2 and Owner 3 became involved, acquiring ** percent of Corp D stock by Year 7.

In the Year 5 and Year 6, Corp D was very successful. Corp D ran Industry N. After setting up Industry N in locations across the United States, Corp D entered into contracts with third party S. Corp D also sold Y. Corp D's assets were intangibles, such as W, X, AA contracts (generally short-term), and Q.

In ** of Year 8, ** percent of Corp D' stock was sold to a venture capital partnership, Entity G,² for approximately \$ **, with a § 338(h)(10) election filed to treat the stock sale as an asset sale. The sale took place ** of Year 8, with a resulting technical termination of Corp D; the new entity was named Corp E

and was also an S corporation. Entity G acquired other similar and/or affiliated businesses and/or companies that became part of Corp E.³ Entity G paid approximately \$ DD in cash and assumed about \$ MM in liabilities for a total price of \$ NN for all the companies and/or businesses it acquired (including Corp D) which became part of Corp E. Owners 1, 2 and 3 continued to hold ** percent of the stock of the new entity, Corp E.

Corp E did not do well. First, there were difficulties operating the company notwithstanding the fact that Owners 1, 2 and 3 of Corp D continued to participate. In **

disqualified persons, considering both salary and the cash flow from the sale; and (3) whether the non-profit should be taxed as a corporation.

² This entity was formed by three other entities: Entity H, Entity J, and Entity K. This entity was formed to acquire Corp D stock.

³ One of the other acquired companies was a former competitor of Corp D.

years, Corp E was in dire financial trouble. Second, the no longer existing entity, Corp D, had overstated the historical sale figures which were relied upon to establish the purchase price of Corp D. In summary, Corp D had three major categories of revenues: QQ, RR and SS for sold Y. Allegedly, the Corp D controller estimated the revenues from the last two categories and overstated said revenues.

Entity G sued Owners 1, 2 and 3, alleging fraudulent overstatement of value, accounting fraud, overstating revenues, understating tax liabilities and overstating pre-paid expenses - all in connection with the sale of ** percent of the stock of Corp D. Corp E also sued the accountants for Corp D, PP, for not properly auditing the overstated revenues. It may be as a result of, or prior to, this lawsuit that Owners 1, 2 and 3 made a \$ WW cash infusion to Corp E and were forced to surrender some of their ** percent stock holding. Owners 1, 2 and 3 countersued Entity G, alleging breach of fiduciary duty and business losses from Entity G's running of the businesses.

In ** of Year 9, Corp E filed for Chapter 11 bankruptcy.⁴ The bankruptcy stayed the lawsuits. Subsequently, Corp E owners did recover some money; but, the recovery against former Owners 1, 2 and 3 was limited by a clause in the sale contract. There was a significant recovery from PP. The amounts recovered are not known.

Prior to, and at the time of the Chapter 11 filing, Corp E was YY throughout the United States; however, all ZZ were released from non-compete clauses to work with competitors upon filing for bankruptcy.

In the fall of Year 9, there was a bankruptcy asset auction. The auctioned assets were reported to include Corp E's AAA operations "BBB" and the following:

[p]roperty and equipment, AA databases, ZZ, employee lists, ongoing contracts, proprietary computer systems, and all intellectual and proprietary rights, including rights to the [Owner 1] CCC and DDD brands.

Source: FF.

Before the bankruptcy and auction sale, Entity G attempted to persuade the former principles in Corp D (Owners 1, 2 and 3) to reacquire Corp E; but, the attempts were not successful. Despite refusing to re-acquire Corp E, from Entity G (the ** percent owner), Owners 1, 2 and 3 purchased the assets of Corp E from the bankruptcy estate for \$ T in an open, multi-bidder, arms-length public auction that Corp F characterizes as highly competitive. The purchased assets were transferred into a new

⁴ The total number of affiliated entities in the bankruptcy is not clear, but it may include: Corp E; Corp D; BBB;

S corporation, Corp F, the entity the subject of this advice. Owner 2 became the more active principal, with Owners 3 and 1 as investors. Owner 2 and his wife owned ** percent, Owner 1 and his wife owned ** percent, and Owner 3 and his wife owned ** percent.

Corp F operated the Industry N business for ** months, but allegedly needed a tax exempt entity to operate its business through in order to save on Z, its alleged largest expense. Corp F has not yet substantiated the assertion its single largest expense is Z or the significance of the reduction in Z. It is not known whether, at the time of the bankruptcy asset purchase, it was planned to dispose of the assets to, or through, a tax-exempt entity.

C. Year 10 Transaction

In Year 9, KK University, a legitimate operating private university in JJ, formed a purported I.R.C. § 501(c)(3) entity called Entity M. As far as it is known, KK University contributed no assets to Entity M. It is not known whether Entity M was formed before or after Corp F acquired the bankruptcy assets for \$ T. Nor is it known what contact or negotiations there were between KK University and Corp F. It is known that, prior to the Year 10 transaction, Entity M did not hold any assets of significance.

In Year 10, Corp F, in form, sold some of the assets it had acquired for \$ T to Entity M for a \$ DD Non-Recourse Contingent Payment Term Note, as further detailed below. It is not known whether there were any negotiations with regard to the selling price, how the selling price was determined, or why Entity M was willing to pay over \$ EE more for the assets than Corp F paid ** months before at the auction sale.⁵ The auditing revenue agent asserts the confidentiality agreement, required of Entity M as set forth below, is the reason this information is not available.

Entity M is operated by Owner 2 (one of the three former principals of Corp D) and the former Corp F employees, with Owner 2 the CEO of Entity M. Owners 1, 2 and 3, the original shareholders of Corp D (which was, in effect, sold twice, once to Entity G and once to Entity M) are receiving W-2 wages for operating Entity M. This arrangement is pursuant to requirements imposed on Entity M, as addressed further below. In Year 12, Owner 2 received \$ ** in W-2 wage, with both Owners 1 and 3 receiving \$ ** in wages; however, it is not known what, if any, services Owners 1 and 3 provided.

⁵ The \$ EE is the \$ DD Non-Recourse Contingent Payment Term Note amount less \$ FF (the \$ T auction cost of the assets less the \$ GG that Corp F allocated to the acquired W that it retained). The use of the Corp F allocation of purchase price to the W does not imply, and no inference can be drawn, that this is the Ws' value. It is not known whether this was an unilateral Corp F allocation but, it may be understated given the W were probably the most valuable asset acquired in the auction.

It is not known what the actual net cash benefit is to Entity M or KK University from participating in the Year 10 transaction, but it is known that after P years neither will have any liability to Corp F or whoever else holds interests in the \$ DD Non-Recourse Contingent Payment Term Note and the separate \$ CC Non-Recourse Contingent Payment Working Capital Note. One exception to this release of liability could be an event of default by Entity M, as further addressed below.

While the cash flow leaving Entity M to KK University is not known, the cash flow in Year 10 to Year 14 to Corp F with respect to Entity M's \$ DD Non-Recourse Contingent Payment Term Note⁶ (not including separate salaries and benefits to the owners of Corp F or the payments on the \$ CC Non-Recourse Contingent Payment Working Capital Note) is as follows:

Year 10	\$**
Year 11	**
Year 12	\$**
Year 13	\$**
Year 14	\$**

Except for less than \$** in Year 14, none of this \$** cash flow to Corp F has been reported on the information return of Corp F (Form 1120S)⁷ as gain in any year (or by any shareholder of Corp F as gain) on the theory the cash flows are solely interest or non-taxable return of basis. In Year 12, Year 13, and Year 14 some of the cash was reported as interest as follows: \$**, \$** and \$**, respectively.

The operative documents for the Year 10 transaction are:

1. The Asset Purchase Agreement.
2. Schedule to Asset Purchase Agreement
3. Note Agreement
4. Non-Recourse Contingent Payment Term Note (\$ DD)
5. Non-Recourse Contingent Payment Working Capital Note (\$ CC)⁸

⁶ The additional cash flow to Corp F from the \$ CC Non-Recourse Contingent Payment Working Capital Note that matured in Year 11, ** years before the Year 15 maturity date on the \$ DD Non-Recourse Contingent Payment Term Note, is not known.

⁷ The Forms 1120S for Corp F were received on the dates specified:

<u>Years</u>	<u>Date Received</u>
Year 10	unknown
Year 11	**/**/Year 12
Year 12	**/**/Year 13
Year 13	**/**/Year 14

⁸ No executed copy was provided, but Exhibit B to the Note Agreement sets forth the contemplated form.

6. Confidentiality Agreements (not provided to the IRS)
7. Security Agreement (not provided to the IRS)
8. W Agreements (not provided to the IRS)
9. Mirror Stock Plan (not provided to the IRS)
10. "Ancillary Documents" (not provided to the IRS)

11. Employment Agreements for Owner 1, Owner 2, Owner 3, and for the other key Corp F employees (not provided to the IRS)

Corp F did not enter into a covenant not-to-compete with Entity M. It is not known in whose name Entity M is doing business i.e., as Entity M or as Corp F or some other "doing business as" name.

The first four operative documents are addressed separately, below, in Sections D through G of the Facts.

D. Year 10 Asset Purchase Agreement

The document titled Asset Purchase Agreement is dated as of **, Year 10. The recitals state Entity M is organized for educational purposes with KK University the "sole member" of Entity M. The recitals further state Corp F provides

A copy of the unaudited **, Year 9 balance sheet of Corp F is attached to the Asset Purchase Agreement.⁹

Article I sets forth various definitions. Article II is titled, and consists of ** pages. Section ** of Article II provides, subject to the other terms and conditions of the Asset Purchase Agreement, that Corp F will transfer to Entity M:

⁹ A reproduction of the unaudited **, Year 9 Balance sheet of Corp F is attached to this Advice as Attachment One.

This totals to approximately \$**, with all of the other assets being intangibles; but, the list of intangible allegedly transferred does not include any of the W acquired by Corp F in the bankruptcy auction purchase.

While not separately stated on the unaudited **, Year 9 Balance Sheet of Corp F, Corp F represents the intangibles had an auction-provided cost basis, and fair market value at time of sale, as follows:

AA ¹⁰	\$ **
W	GG
X	
•	**
•	**
	\$ **

Corp F further represents that the goodwill and going concern had an unknown value at the time of the sale. This information is from page 3 of the document submitted during the audit entitled “Outline of Tax Issues Related To Sale of Assets by Corp F.” It is not known whether the above Corp F proposed value/cost allocations were based on arms-length adverse negotiations during the auction purchase or were unilaterally assigned values after a bulk purchase.

Section ** of Article II specifically excludes all W from the Year 10 transaction, as well as Corp F’s books and records. The W are to be licensed to Entity M with the option to purchase. No copies of the licenses, if any actually exist, were provided to the IRS. It is not known whether Corp F received royalties or other payments based on the licenses, if ever executed.

Section ** of Article II sets the total sales price at \$ DD. At closing, Entity M is to deliver a non-recourse contingent payment promissory term note to Corp F for \$ DD (sometimes referred to herein as “Term Note”). In addition, Entity M is to execute a \$ CC Non-Recourse Contingent Payment Working Capital Note (“Working Capital Note”) so Corp F can loan Entity M working capital for the business that is to use the assets. Both notes are to be secured by a pledge of Entity M’s assets that includes the Year 10 transaction-acquired assets to operate the business and after acquired assets, as presumably stated in the Security Agreement. No copy of the Security Agreement was provided to the IRS.

¹⁰ The AA are not separately listed in the operative documents reviewed. For the purpose of this advice, it is assumed, without verification, that these were transferred. This “fact” needs to be verified.

Section ** of Article II provides Entity M will assume: (a) \$ ** of liabilities disclosed on the unaudited **, Year 9 Balance Sheet of Corp F and all expenses/costs of Corp F incurred after **, Year 9 but before closing (including accounts payable, obligations to conduct Industry N and more); (b) all liabilities and obligations under assumed contracts,¹¹ and (c) all liabilities and obligations from ownership or operation of assets or Industry N after closing.

Section ** of Article II excludes certain tax obligations and other pre-closing tax obligations of Corp F, liabilities or obligations from the “Mirror Stock Plan” in Section **, and certain other unrelated obligations and liabilities. The “Mirror Stock Plan” is not explained in Section **; however, there is a short paragraph on the “Mirror Stock Plan” in Schedule ** of the Disclosure Schedule, addressed below. No copy of the “Mirror Stock Plan” was provided to the IRS.

Article III is titled _____ and, except as stated otherwise in the “Disclosure Schedule,” represents Corp F has the authority and legal capacity to sell and that the Asset Purchase Agreement is enforceable. Corp F represents in Section ** that it has used the assets in the business of “Industry N” (stated in “Recitals” to be

_____).
Section ** represents that the Assumed Contracts are all material contracts. Sections ** and ** address intellectual property, with said property (including W) listed in Schedule **, addressed below. Section ** is titled _____ and cross references Section ** of the Disclosure Schedule, addressed below. Various compensation, retirement and other plans are listed, with it represented that Entity M received copies of the plans. No copies of the plans were provided to the IRS. It is represented that no application for rulings, determination letters, advisory opinions or prohibited transaction exceptions are currently pending before the IRS.

Article IV is titled _____ Entity M represents itself to be a private non-profit corporation described in I.R.C. § 501(c)(3), exempt from federal income taxes, and not a private foundation, without any material “unrelated business taxable income” as defined in I.R.C. § 512. Entity M represents Section ** of the Asset Purchase Agreement and each Entity M “Ancillary Document” are enforceable against Entity M, but does not list the “Ancillary Documents.” Entity M delivered copies of its articles of incorporation, bylaws and minute books to Corp F, but none were provided to the IRS.

¹¹ Listed in Schedule ** “Assumed Contracts,” addressed below.

Article V is titled _____ and provides, among other provisions, that both parties shall have opinions of counsel delivered to the other party.

Article VI is titled _____ with Section ** requiring that Entity M enter into employment agreements with Owner 2, HH, Owner 1, and Owner 3, to the satisfaction of each owner and HH.¹² No copies of the employment agreements were provided to the IRS. Section ** references a Security Agreement; however, no copy was provided to the IRS. Section ** requires licensing of the W by Corp F to Entity M, but no copies of the licenses (if any exist) were provided to the IRS.

Article VII is titled _____ with Section ** requiring Corp F to indemnify and hold Entity M harmless for all expenses, including legal fees for Corp F's misrepresentations, Corp F's failure to comply with agreements, and other matters. Section ** has a less stringent indemnification by Entity M. Section ** provides Corp F's indemnification will be offset by Entity M obligations in accordance with Section ** of the Note Agreement.

Article VIII is titled _____ with Section ** having a confidentiality clause and referencing a prior confidentiality agreement and Section ** of the Note Agreement. No copies of any confidentiality agreements were provided to the IRS. Public disclosure of the transaction, if any, is limited by Section **. In Section **, Corp F agrees to use its best efforts to obtain consents referenced in Section ** of the Disclosure Schedule. Section ** addresses the letters of credit that Corp F caused a bank to issue to as disclosed in Section ** of the Disclosure Agreement, and it is agreed these letters of credit will stay in place to assure Entity M's performance. In Section **, Entity M agrees to hire all Corp F employees.

Article IX is titled _____ with Section ** allowing the Asset Purchase Agreement to be amended by the parties at any time.

The Asset Purchase Agreement is silent as to disposition of the assets should Entity M default on the \$ DD Non-Recourse Contingent Payment Term Note or at the expiration of the P year Note Agreement term. Thus, it may, or may not be, that all assets would revert to Corp F; however, the operative documents that were not provided to the IRS may have provisions that impact the ultimate ownership of the assets.

¹² Only Owner 2 and HH were disclosed as employees of Corp F in the Disclosure Schedules addressed, below.

E. Schedule to Asset Purchase Agreement

There is a separate document titled "Schedules to Asset Purchase Agreement Between Corp F. and Entity M;" however, it has no index. The documents included in the copy provided to the IRS were:

1. Schedule ** (** pages) with "Attachment " (** pages), addressed further below;
2. Schedule ** (** paragraph);
3. A document with a typed paragraph, as follows.

The documents following the page with the above quoted legend were as follows:

- a. Attachment to Schedule **, Unaudited balance sheet of Corp F as of **, Year 9, addressed above and further addressed below (reproduced copy attached to this advice as Attachment 1);
- b. Schedule ** " (** paragraphs, addressed further below);
- c. Schedule ** (** paragraphs), with ** paragraph disclosing ;
- d. Schedule ** (** paragraphs), with one paragraph disclosing Corp F does not own certain intellectual property used in the business;

- e. Schedule ** (** paragraphs),
with the second paragraph stating

- f. Schedule ** (** page), with
Attachment (** pages) listing W and Attachment
(** pages) listing X (addressed further below);

- g. Schedule ** (** paragraphs), discloses

- h. Schedule ** (** page) discloses

- i. Schedule ** (** pages);

- j. Schedule ** (** page);

- k. Schedule ** (** paragraph)
discloses

- l. Schedule ** (** paragraph)
discloses that

- m. Schedule ** (** paragraphs)
discloses

There are no other schedules in the documents provided to the IRS. There is no reference to any agreement by Corp F to restrict its competition with Entity M or to cease doing business in the same industry.

The above referenced Schedule ** lists:

** service agreements; ** car rental agreements; ** contracts; ** contract; ** contracts; ** contracts and listings. The remaining items are primarily AA, BB or ZZ contracts; however, the contract periods are given as a single date. There are ** AA contracts dated Year 10, ** AA contracts dated Year 12, and ** AA contracts dated Year 13. The BB agreements are similarly dated with ** agreement dated Year 9 and ** agreements dated Year 10. The ZZ contracts are also dated similarly with ** contracts dated Year 9 and ** contracts dated Year 10. Only the contracts have clear end dates as follows: ** ending in Year 10, ** ending in Year 11 and ** ending in Year 12.

The above referenced Schedule **, the ** page unaudited **, Year 9 balance sheet of Corp F, has \$ ** of assets and the same as liabilities. There are no footnotes or explanations. See Attachment One to this advice, below (reproduction of Corp F unaudited **, Year 9 balance sheet).

The above referenced Schedule ** discloses Corp F had to pledge almost \$ ** in certificates of deposit (“CDs”) during its ** months of operations to secure certain business actions/contracts. No information was provided as to how, or when, acquired (or borrowed) the CDs. Corp F discloses it is attempting to obtain releases of the pledged CDs, with it unclear whether, in part, the \$ CC working capital Corp F will loan to Entity M is to be applied in lieu of the CDs. Schedule ** further discloses that Corp F has adopted a “Mirror Stock Plan” as of **, Year 10, shortly before the effective date of the Asset Purchase Agreement. The disclosure does not state whether this “Mirror Stock Plan” is mirror to the Holder Certificates provided for in the Note Agreement, addressed below. Entity M does not assume the obligations under the “Mirror Stock Plan.” No copy of the “Mirror Stock Plan” was provided.

The above referenced Schedule ** has the X that the Asset Purchase Agreement transferred to Entity M listed separately from the W that Corp F excluded from the Asset Purchase Agreement. Many of the X are old with

The dates range from Year 5 to Year 7, with ** from the Year 5, ** from Year 6 and only ** from ** to Year 7.

F. Note Agreement

The Note Agreement, dated **, Year 10, is between three parties:

- Entity M
- Initial Holders of notes listed in Schedule ** to the Note Agreement.
- Corp F

The “Recitals” provide Entity M will execute the \$ DD Non-Recourse Contingent Payment Term Note and Corp F will loan Entity M \$ CC for Non-Recourse Contingent Payment Working Capital Note. The “Recitals” further provide Entity M is granting Corp F (as representative of the Initial Holders) a security interest and that there is a separate Security Agreement. The provisions of the Note Agreement govern both non-recourse contingent payment notes and the obligations of Entity M with respect to both notes (i.e., term and working capital). No copy of the security agreement was provided.

Article ** has the definitions and rules of construction. “Holders” is defined to be those in whose name a Note is registered in the Note register. “Note” or “Notes” are the Term Note and Working Capital Note, or any future division of, or re-issuance of, said notes. Notes can be freely transferred pursuant to the terms of the Note Agreement, according to the definition of “Notes.” Although the Note register is not defined, it appears that this references Entity M’s obligation to obtain a “Certificate”

that
acknowledge the rules applicable to the ** allowed “Owners” (defined as “Holders” of the Term Note and Working Capital Note) and to track these owners.

Article II is titled Section **, again, addresses “Term Notes,” which label includes the \$ DD Non-Recourse Contingent Payment Term Note and all subsequent divisions and/or replacements.¹³ The Term Notes are to be “registered” by Entity M in the names of the Initial Holders in the amounts as set forth in Schedule **. Pursuant to Section **, the Term Notes shall be dated **, Year 10 with a maturity date of **, Year 15 and bear ** percent interest per annum. The amounts labeled principal and interest are payable solely out of the following:

Profit

¹³ It is not known whether the \$ DD Non-Recourse Contingent Payment Term Note was subdivided, amended or reissued, i.e., “replaced”.

As long as there is no “Event of Default,” Entity M has no obligation to make any other payments on its \$ DD Non-Recourse Contingent Payment Term Note

Pursuant to Section ** Corp F shall loan Entity M \$ CC for working capital with Entity M to draw on once per month at minimum draws of \$ **. The maturity date of the \$ CC Non-Recourse Contingent Payment Working Capital Note is **, Year 11, ** years before the maturity date Entity M’s \$ DD Non-Recourse Contingent Payment Term Note. As with the \$ DD Non-Recourse Contingent Payment Term Note, the \$ CC Non-Recourse Contingent Payment Working Capital Note is payable only from “Profit” and no other payment is otherwise due unless there is an “Event of Default.”

Section ** “Profit,” provides the “Profit” shall be computed quarterly by Entity M’s Chief Financial Officer (Owner 2) and delivered to Corp F and each Holder. Entity M shall pay the “Profit” to the Holders within ** days of the expiration of each quarter. Thereafter, ** days after the close of each fiscal year, Entity M shall deliver to Corp F a report prepared by an independent certified public accounting firm of the “Annual Profit,” with detailed provisions for confirmations of amounts.

Pursuant to Schedule ** and ** to the Note Agreement, “Profit” is :

Both Schedule ** and Section** provide that the Profit payments will be made in the following order:

1. \$ CC Non-Recourse Contingent Payment Working Capital Note;
2. Interest on the “Term Notes”,¹⁴

¹⁴ It is not known how many Holders exist.

3. ** percent to principal and ** percent to Entity M, with Entity M allowed to make charitable donation of its share to KK University.¹⁵

Section ** further provides that interest continues to accrue on unpaid principal and accrued interest at ** percent per annum. Special rules are provided for the final computation, increasing the payment to Corp F. Entity M may pre-pay the working capital note. Section ** provides details on the method and place of payment by check or electronic transfer. Section ** states that all “Term Notes” are to be in the form set forth in Exhibit A.

Section ** addresses substitutions and modifications of “Term Notes,” i.e., the \$ DD Non-Recourse Contingent Payment Term Note, and allows for subdivision of the note limited to a maximum of ** notes outstanding, and in amounts of no less than \$ **. Term Notes may only be transferred or exchanged upon the Note Register maintained by Entity M. When Term Notes are transferred, a “Certificate”¹⁶ will be executed by the transferee and the transferee must provide a tax identification number. Transfers must be exempt from registration requirements of the Securities Act and applicable state laws. Entity M shall be reimbursed its costs.

Entity M is not required to transfer or exchange Term Notes selected for prepayment in whole or part. Entity M is charged with keeping records of Holders with serial numbers of all Terms Notes. Term Notes can be held by any stockholder of Corp F and anybody else per Entity M’s consent, with said consent not to be unreasonably withheld. Holders must receive equal treatment pursuant to Section **. The Working Capital Note is different; Entity M has sole discretion on who can hold said note. There are limits on Entity M’s acquisition of interests in Holders.

Article ** (** paragraph) is titled _____ and cross references the required Security Agreement. No copy of the Security Agreement was received.

Article ** is titled _____ Numerous obligations are imposed on Entity M, such as maintaining all property useful to conducting the Industry N business and conducting the Industry N business. Entity M is precluded from engaging in any other business or activity. The Holders have power and authority over Entity M as set forth in the Note Agreement. Entity M can administer the assets only in compliance with the Note Agreement. Pursuant to Article **, Entity M must pay all taxes and cannot incur debt, except as allowed in the Note Agreement. Entity M must hold its stockholders, directors, officers, employees and agents harmless from any

¹⁵ The ** percent appears to be all Entity M receives from the Industry N business operated by Owner 2 with Corp F employees.

¹⁶ The certificate is to be in the form as set forth in Exhibit ** to the Note Agreement.

liabilities, etc., arising out of the Note Agreement. Entity M shall carry insurance as specified and keep books and records as specified. Limits are placed on Entity M's authority to sell, lease or dispose of property. Entity M cannot consolidate or merge with another entity, form a subsidiary, loan money, hold stock or perform any activity prohibited in Article **. In Section **, if Owner 2 can no longer serve as Executive Director and Chief Executive Officer, Entity M shall elect Owner 3 on the same terms.

Article ** is titled "Events of Default" are listed in Section ** as the following:

- Entity M's failure to pay per the Note Agreement provisions;
- Entity M's failure to conform with the obligations and restrictions of the Note Agreement;
- Entity M challenging the Note Agreement;
- Any material provision of Note Agreement, Term Notes, or Working Capital Note being declared void by any court;
- The Security Agreement ceasing to be in full force and effect;
- Owner 2 (or Owner 3) resigns for "good reason" or is discharged without "just cause" (as said terms are defined in the separate employment contracts, copies not provided) unless Entity M pays \$ DD and all accrued interest in full;
- Adverse changes in Entity M's ability to generate "Profit"; or
- Entity M ceases to be wholly-controlled by KK University.

If an event of default occurs, it may be that Entity M must pay the full \$ DD pursuant to Sections ** through **; however, that is not clear in the Note Agreement.

Article ** is titled _____ and imposes liability on the representative for its own negligence, misconduct or bad faith. The representative is entitled to separate compensation and reimbursement, and can be replaced by the decision of the majority of the Holders. The representative is not specified in Article **.

Article ** is titled _____ and empowers Entity M and the representative to amend the Note Agreement under certain circumstances.

Article ** is titled _____ and, among other provisions, provides notice to a representative is sent to Corp F, attention Owner 2, with a copy to the attorneys for Corp F. The representative is precluded from using the name of Entity M or KK University. The Holders warrant they understand the Note Agreement and the Term Notes are not registered. Section ** specifically clarifies that the notes are non-recourse to Entity M. The Note Agreement is signed by Owner 2 as representative for Corp F, and also signed by him as initial noteholder for Corp F.

G. Term Note

The document entitled “Entity M Term Note” is ** pages long. At the top of the first page there is a large font all capital letters, ** page disclosure that the Term Note has **not been registered**, with offers to sell, or sales, prohibited unless registered, with additional limitations and warnings. In the first full paragraph, it states:

Buyer’s obligation to make payment of principal and interest on this Note is limited to the Profit

The _____ addresses the “initial noteholders” and Corp F as a representative of the “initial noteholders.” The section references the Note Agreement and Collateral,

The “Payment Table” section provides unpaid interest is to be added to principal. Entity M is charged with maintaining payment records. There are provisions for exchange of the note and a limitation on transferability. The Holder of the note has no right to the note, except as provided in the Note Agreement. The note can be modified as provided in the Note Agreement.

H. Corp F Position

Corp F submits the Year 10 transaction is a contingent payment sale of assets and that it can use the installment method of accounting pursuant to § 453. Corp F further submits that, for the asset sale, under Treas. Reg. § 1.338-6(b)(2), all sale proceeds in excess of the cost basis are for goodwill and going concern.

Corp F asserts, for the assets in Class I-VI, the fair market value of the assets sold was equal to the tax basis of such assets. Specifically, Corp F states:

“In computing its gain from the Sale in **, Year 10, the Company has taken the position that for the assets in Classes I-VI, the fair market value of the assets sold was equal to the tax basis of such assets. This position is supported by the fact that only ** months prior to the Sale, the Company [actual Owners 1 through 3] had purchased

the Class I-VI assets in a **hotly-contested, multi-bidder auction**. The Company believes that the price paid by the Company for the Class I-VI assets at arms-length auction (i.e., the Company's tax/cost basis for the assets) was the best indicator of the fair market value of the Class I-VI assets at the time of the Sale (which as stated occurred only ** months after the auction)¹⁷ (emphasis added)

Corp F further asserts that it can allocate all payments to Classes I-VI in succession, exhausting each Class before proceeding to the next. Corp F asserts for Classes I-VI, the gross profit percentage is ** percent, on the theory that the fair market value of each asset in Classes I-VI equaled its tax basis. Only when Corp F has exhausted Classes I-VI basis, it asserts, will the remaining payments be allocated to the sale of Class VII assets and that is the first time there will be any recognizable gain.¹⁸ The amounts so allocated, accordingly to Corp F, will be short-term capital gain.

Corp F contends that none of the assets that it acquired in the Year 9 bankruptcy liquidation auction were "goodwill" or "going concern" given the bankruptcy. Corp F asserts all "goodwill" and "going concern" sold to Entity M arose from combining the assets acquired in the bankruptcy liquidation auction "with a skilled management team, employees, etc., and infusing working capital during the ** month holding period."¹⁹ Corp F has not supported its assertions of valuable goodwill and going concern being generated in the ** month holding period with an independent third party appraisal. Corp F has not explained how the alleged goodwill and going concern were generated in ** months rather than being (potentially) generated in the future ** year term of the \$ DD Non-Recourse Contingent Payment Term Note. Nor has Corp F explained how it could have generated such goodwill and going concern value when it allegedly cannot operate at a profit without the Z Entity M can obtain as a non-profit entity. Corp F has not provided any evidence that the "extra" cost savings from the Z Entity M could command, when compared to the tax benefits at issue, is significant.

Corp F then concludes its Year 10 transaction constitutes a sale that falls within Temp. Treas. Reg. § 15a.453-1(c)(2) "Stated Maximum selling price" contract and is reportable using the installment method of accounting. Corp F did not apply § 453A.

While Corp F advances a discussion of the treatment of property used in its trade or business and "subject to the allowance for depreciation" as reportable ordinary

¹⁷ Outline of Tax Issues Related to Sale of Assets By Corp F, submitted to revenue agent during audit, at 1.

¹⁸ It is not known whether the \$ T auction purchase price was separately financed, i.e., the amount of cash "out of pocket" for Corp F is not known.

¹⁹ See note 23, above

income rather than capital gain, Corp asserts said provisions are inapplicable given it had no gain because the assets were sold at cost. No information is provided as to depreciation, if any, claimed during the ** months Corp F held the assets while conducting business and, allegedly, generated the goodwill and going concern value.²⁰ Corp F now, apparently, takes the position that no inventory transferred to Entity M notwithstanding the text to the contrary in the Asset Purchase Agreement.²¹

I. The Audit

None of Corp F's Federal income tax returns were examined until the Year 13 return; however, it is known from the examination of the Year 13 return that the income from the Year 10 transaction has been under reported. The revenue agent proposes to tax all deferred income from Year 10-Year 12 through an I.R.C. § 481 adjustment in Year 13, in addition to increasing the Year 13 income from the transaction.

LAW AND ANALYSIS²²

The Internal Revenue Code defines "gross income" as "all income from whatever source derived," including "[g]ains derived from dealings in property." I.R.C. § 61(a)(3).

For dispositions of property via sales or exchanges, the gain from the sale equals the "amount realized" by the taxpayer minus the taxpayer's adjusted basis in the property. I.R.C. § 1001(a). The "amount realized" is "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b). Accordingly under said section, "[e]xcept as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section on the sale or exchange of property shall be recognized." This is the general rule, with any deferrals or exceptions a matter of legislative grace.

For gain from debt instruments issued for property, Treas. Reg. §1.1001-1(g)(1) provides, in general, that "[i]f a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under [Treas. Reg.] §§1.1273-2 or 1.1274-2, whichever is applicable." Said provision is not applicable to a debt instrument subject to Treas. Reg. §§1.1275-4(c) or 1.483-4. Reg. § 1.1001-1(g)(2)(i). See Reg. §1.1001(g)(2)(ii). Reg.

²⁰ Id. at **.

²¹ The facts relative to inventory must be further developed.

²² Given Corp F is a pass-through entity, the S Corporation shareholders are the taxpayers that must recognize the income; however, this advice does not address how the income flows to said taxpayers. Rather this advice address the income as it flows into Corp F. This advice does not extend to the alternative minimum tax considerations at the individual level, or other individual ramifications.

§1.1275-4(c) “generally applies to a contingent payment debt instrument that is issued for non-publicly traded property.” Reg. §1.1275-4(c)(1).

I.R.C. § 1001(d) cross references the use of installment method, if applicable, that allows deferral of recognition as provided in I.R.C. § 453. Section 453(a) provides that, except as otherwise stated, income from an installment sales shall be taken into account under the installment method. Section 453(b)(1) defines an installment sale as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Section 453(c) defines the installment method as a method of accounting under which the income is recognized for any taxable year from a disposition of property being 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 transactions where the gross profit or the total contract price (or both) cannot readily be ascertained.

Temp. Treas. Reg. §15A.453-1(c)(1) 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. In general, non-dealers with a contingent payment sale report income pursuant to the installment sale method of accounting by allocating payments received among:

- Gain
- Partial return of basis
- Interest (imputed or internal, as applicable)

I.R.C. § 453; Temp. Treas. Reg. § 15A.453-1.

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 transactions, regardless of the existence of a stated maximum selling price or fixed payment terms. Temp. Treas. Reg. §15A.453-1(c)(1). The regulations promulgated pursuant to § 453 distinguish a sale from the acquisition of an equity interest, with an equity interest not a debt instrument.

The aforementioned broad framework of the law, as applied to the subject transaction, is addressed in the context of each stated issue, below.

Section 1 Substance of the Transaction

While the Year 10 transaction is cast, in form, as a sale of assets, in substance, Corp F has not relinquished dominion and control of the assets. Corp F continues to run its Industry N business using its retained rights in the assets. Thus, in substance, there was no asset sale for tax purposes. As stated in Estate of Franklin v. Commissioner, 64 T.C. 752 (1975), aff'g Estate of Franklin v. Commissioner, 544 F.2d 1045, 1047 n.1 (1976):

“[W]hile characteristics of a transaction are questions of fact, whether those characteristics constitute a sale for tax purposes is a question of law” (emphasis in original, citations omitted)

To paraphrase the reasoning in Estate of Franklin, the lack of a price that approximately equals the fair market value leaves the transaction lacking the substance to justify treating the transaction as a sale ab initio. 544 F.2d at 1048. Whether or not Corp F (through Owners 1, 2 and 3) believed that the businesses formerly acquired by Entity G could be worth \$ DD after the bankruptcy, there is no evidence the few assets from the business that Corp F allegedly sold could be worth \$ DD at the time of the purported sale. The fact the “sold” assets were purchased for approximately \$ R (\$ T less retained W)²³ in an arms length, open bid, hotly contested auction ** months earlier is compelling evidence that the assets were only worth \$ R. If Corp F could not make a go of the business without the Z that a non-profit organization could command, that is additional evidence the value did not increase over \$ EE²⁴ in the intervening ** months that Corp F held the assets.

Moreover, while Corp F asserts that the increased value (\$ EE) is either going concern or goodwill, the evidence is to the contrary. As noted above, Corp F allegedly could not make a “go” of the business without Entity M. From a review of the list of short-term AA contracts, it appears that the AA contracts are old or relatively few. Most of the BB agreements and ZZ contracts pre-date the purchase of the assets in the bankruptcy auction. All ZZ were released from their non-compete clauses prior to the bankruptcy auction. It will take future development to turn these assets into a \$ DD business, if such a success is possible. To the extent Corp F is anticipating creating goodwill by running the business through Entity M for P years that does not bring Year 10 value to the purported sale of miscellaneous older assets.

²³ The \$ R is, in exact amounts, \$ R. This amount is based on Corp F’s representation it paid \$ T for all of the assets acquired in the bankruptcy auction with \$ GG of said \$ T paid for the W. The W were retained by Corp F. If the amount allocated to the W was not a negotiated arms length amount, said amount may be too low of an allocation because W are probably the most valuable asset acquired.

²⁴\$ DD less \$ R.

Similar to taxpayer in Estate of Franklin, Corp F failed to provide any support for its conclusion that the \$ DD purchase price was at least approximately equivalent to the fair market value of the assets sold. As stated by the Ninth Circuit, “[i]n our view this defect in the taxpayer’s proof is fatal.” 544 F.2d at 1048. See Wrenn v. Commissioner 67 T.C. 576 (taxpayers not entitled to deferral benefits of § 453 because they did not establish the transfer was a bona fide sale for tax purposes in substance as well as form).

Thus, there is no sale for tax purposes; rather, Corp F continues, in substance, to own all the assets with all income of the business income of Corp F. Corp F used a method of accounting (installment method) that failed to clearly reflect its income from its business that it continued to run. While only the Year 13 is under audit, all deferred income from Year 10-Year 12 can be included in Year 13 as set forth in Section 5, Applicability of § 481, below.

The economic substance doctrine, applied above, disregards the transaction, i.e., there is no sale. The doctrine of substance over form recasts the transaction. As a first alternative, you should recast the transaction. Assuming arguendo the Z could be a significant expense reduction necessary to generate profits, the transaction would be recast as Corp F and Entity M having entered into a partnership that failed to file any tax returns, with Corp F the ** percent income partner and Entity M the ** percent income partner pursuant to the allocation of the “Profit,” and taxed accordingly. As a second alternative, you should assert Corp F and Entity M formed a C corporation, with the mirror stock plan and holder certificates representing the corporate shares. For that alternative, the corporation failed to file corporate tax returns, failed to pay the corporate level tax and failed to pay the shareholder level tax.²⁵ All

would be dividends subject to a second level of tax, and should be taxed accordingly.

As support for both the position that Corp F, in substance, retained ownership of the assets and the positions that it formed new entities with Entity M, it is noted that Corp F provides the working capital to run the business. Entity M has no right to run the business; rather, one of the owners of Corp F must be the CEO and Entity M must hire the Corp F employees or Entity M is in default under the terms of the Note Agreement. Entity M cannot sell the assets it purportedly purchased and would, presumably, forfeit all assets back to Corp F in the event of a default. The default provisions are strict – in essence giving Corp F complete control.

Either Corp F retained its ownership in the assets or Corp F and/or its principals hold what is, in substance, equity interests so installment reporting does not apply. Corp F cannot be allowed to defer its income and convert ordinary income (income from

²⁵ Note that this recast requires C corporation treatment, not S corporation treatment.

running the business) to capital gain income via the Year 10 transaction. All alternatives must be asserted to preclude such treatment.

Section 2 The Term Note is Not a Debt Instrument

Corp F is not eligible for the tax deferral benefits of § 453, as addressed above. Likewise, based on the facts, neither the \$ DD Non-Recourse Contingent Payment Term Note nor the \$ CC Non-Recourse Contingent Payment Working Capital Note are contingent payment debt instruments.

While the absence of personal liability by Entity M does not cause the note, ipso fact, to be a non bona fide debt, as in Estate of Franklin, because the debt has economic significance only if the business generates substantial profits, there has been no creation of an instrument that

secured 'the use or forbearance of money.' (citations omitted) Nor has the seller advanced money or forborne its use. (citations omitted) . . . [T]he absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise.

544 F.2d at 1049.

As opined in the Estate of Franklin

[F]or a debt to exist, the purchaser, in absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make capital investment in amount of unpaid purchase price.

544 F.2d at 1049

See Rev. Rul. 77-110, 1977-1 C.B. 58 (taxpayer's inability to demonstrate the fair market value of the property at least approximated the amount of the non-recourse note precludes including note amount in the basis for depreciation purposes and precludes deducting the interest). See also, Rev. Rul. 84-5, 1984-1 C.B. 32 (non-recourse obligation did not constitute a valid indebtedness).

Section 3 Proper Application of §453

Alternatively, if a sale, the installment method applies. Corp F has disposed of property with payments due after the close of the year in which the sale occurs. Accordingly, if a sale, the transaction is an installment sale, and it is a contingent

payment sale. See Temp. Treas. Reg. §15A.453-1(c)(1). Corp F is not a dealer in property, so it must report the payments under the installment method pursuant to § 453 unless the assets being sold are inventory,²⁶ the transaction is otherwise disqualified, as addressed above as the primary position, or the taxpayer properly elected out of installment method reporting. §§ 453 (a), (b) and (j).

Pursuant to Temp. Treas. Reg. § 15A.453-1(b)(2), applied using the contingent payment rules of Temp. Treas. Reg. § 15A.453-1(c)(2), each payment shall be allocated between taxable gain and return of basis by applying the gross profit ratio computed for the transaction. In general, the gross profit is the selling price less the seller's adjusted basis (including expenses of sale). The gross profit factor (percentage) is the gross profit divided by the contract price. Said gross profit factor is applied to the aggregate contingent payment amounts received in each taxable period/year to arrive at the annual reportable gain, after allocation to interest, as discussed below. There are specific rules for computing the initial selling price, contract price and gross profit. The applicable regulation section depends on whether the transaction constitutes a sale for which: (a) the maximum selling price is determinable, (b) the maximum selling price is not determinable but the time over which payment will be received is determinable, or (c) neither a maximum selling price nor a definite term is determinable. Temp. Treas. Reg. § 15A.453-1(c)(1).

Pursuant to the terms of the Asset Purchase Agreement, the maximum selling price is set in the operative documents so it is a determinable maximum as of the first year of the contract. Temp. Treas. Reg. § 15A.453-1(c)(2)(i)(A). Whatever Corp F's current speculation is as to how much will actually be paid, the regulations clearly provide that the stated maximum selling price is determined by assuming all contingencies are resolved in a manner that maximizes the price and accelerates payment. Temp. Treas. Reg. § 15A.453-1(b)(2). Temp. Treas. Reg. § 15A.453-1(c)(2)(i)(B), Ex. (1) and (2).

Applying these regulations, the selling price is \$ DD, all obligations assumed by Entity M, all expenses of Corp F paid by Entity M and the working capital note which is

²⁶ The taxpayer now, apparently, asserts no inventory was transferred. If inventory was transferred, it is excluded from the installment sale provision. § 453(b)(2)(B); Temp. Treas. Reg. § 15A.453-(b)(4). See C.W. Murry v. Commissioner, T.C. Memo 1993-471 (the price of inventory had to be excluded from the installment method computation). Corp F cannot claim it purchased inventory, in bulk, from the bankruptcy proceeding as an investment for the purpose of turning over a profit given the assets were used in its trade or business. See W.F. Glisson v. Commissioner, T.C. Memo 1981-379 (the character of the parts sold changed from inventory to investment assets based on the facts). Thus, all gain, if any, from inventory sales must be immediately recognized as ordinary income, with the income recognizable in Year 13 pursuant to I.R.C. § 481.

an integral part of the Year 10 transaction.²⁷ Thus, Corp F has understated the selling price. Corp F has overstated its basis in that the value of the retained W must be subtracted from the claimed basis of \$ T. The basis would be no more than \$ R (the \$ T purchase price paid for the assets ** months prior to the sale less the \$ GG amount Corp F allocated to the retained W, assuming the allocation was not understated). The one gross profit ratio, computed with the correct amounts, applies to each principal payment starting with the very first payment; there is no separate zero percent gross profit ratio for the initial principal payments. This position should be asserted as an alternative to the treatment in issue one, above, if the case is unagreed.

Corp F concurs that, if a sale, the form of its transaction is a contingent payment sale with Temp. Treas. Reg. § 15A.453-1(c) applicable, but argues the sale is divisible into seven separate sales with potentially seven different gross profit ratios, applied serially. According to Corp F, each sale represents a sale of assets within a single asset class. Corp F argues that separate sale treatment with different gross profit ratios is mandated by Treas. Reg. § 1.1060-1(c)(2) and Treas. Reg. § 1.338-6. Thus, Corp F concludes it can treat payments up to the fair market value in each separate class as a separate sale with the result that no gain is reportable, at all, until it starts receiving payments for the Class VII asset sale. In other words, in effect, the one gross profit ratio correctly computed as stated above, cannot apply to any payment until \$ T cash is received tax free because the first six sales have a zero gross profit ratio in that the cost basis equals the selling price in each sale.

Corp F relies primarily upon Priv. Ltr. Rul. 200004040 (October 29, 1999) to support its position. 2000 WL 92408 (IRS PLR) issued January 28, 2001/October 29, 1999. PLR 200004040 addresses six ruling requests with respect to application of I.R.C. § 468 on nuclear decommissioning and its interrelationship with I.R.C. §§ 671-678 (grantor trusts), § 165, and §1060. Corp F focuses on ruling request number four wherein the PLR addresses the acquiring taxpayer's basis in nonqualified decommissioning funds in the context of the first three rulings on § 468. Corp F applies the rulings with respect to the purchaser to itself, as seller, relying on conformity of treatment.

The taxpayer-purchaser in the PLR argued § 1060 did not apply so the assumed decommissioning liability could be allocated to its cost basis in the nonqualified funds. In response, the PLR notes that the assumed liability cannot be treated as incurred for federal income tax purposes until economic performance, citing to Reg. §§1.446-1(c)(1)(i)(ii)(A) and 1.446-1(c)(1)(ii)(B), then finding economic performance does not occur for decommissioning obligations until the costs are incurred in satisfaction of the liability – an event that may not occur for sixty years in the situation addressed. Hence the basis was limited to the cash component.

²⁷ There is a possibility the working capital note could be a contribution to capital; however, there are insufficient facts to support that treatment as the case is presented. Should the taxpayer provide additional information, please request supplemental advice.

The PLR then addressed how to allocate the cash component, rejecting the purchasing taxpayer's attempt to first divide the sale in two sales, i.e., plant assets and decommissioning fund liability, with all basis to the plant assets. The PLR rejected the divisibility argument as having no support.²⁸ Nowhere does the PLR address § 453 or state the residual method allows, in essence, open transaction reporting for the seller by dividing one sale into separate sales.

While PLR 20004040 is too inter-twined with the special provisions on nuclear power plants to be considered as supporting Corp F, to the extent a non-citable non-precedential PLR could be binding authority (it cannot), the applicable principle from the PLR would be that, as the taxpayer in the ruling could not arbitrarily bifurcate its transaction, Corp F cannot arbitrarily bifurcate its transaction into seven separate sales. The PLR provides no support for Corp F's argument that § 453 allows a seller's reporting of gain be separated into seven separate sales to avoid the ratable basis recovery rules of § 453.

Corp F also relies on Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), to claim that § 453 applies asset by asset, and on Rev. Rul. 68-13, 1968-1 C.B. 195,197 which states:

[T]he sale of a business must be 'comminuted into its fragments' where either the selling price or the down payment, or both of them, is separately stated with respect to different assets or types of assets in the agreement of sale. In this connection, it also should be noted that losses, where separately determinable, must be reported in the year of sale. (citation omitted)

Rev. Rule 68-13 is not saying a taxpayer can divide a single transaction for immediate loss recognition and deferral of gain, or that the ratable basis recovery rules are moot. The ruling must be placed in the context of the citation in the ruling to Monaghan v. Commissioner, 40 T.C. 680 (1963), acq. 1964-2 C.B. 3 and Williams v. McGowan, 152 F.2d 570 (2nd Cir. 1945). These cases considered the exclusion of inventory from installment reporting and the old requirement that, in the year of sale, payments cannot exceed 30 percent of the price. Neither this revenue ruling nor the cases nullify the ratable basis reporting required by § 453 as amended in Year 5 for contingent payment sales; these authorities are directed at determining the character of the gain and the old 30 percent rule.

²⁸ The § 1060 regulations relative to the residual method require the allocation to Classes IIV pro rata according to their fair market value, and addresses the impact of the buyer's satisfaction of economic performance of liabilities assumed on the purchase price.

In Monaghan, the Tax Court stated:

The sale of a going business . . . has long been considered as a sale of the separate business assets for purposes of ascertaining whether profit result in capital gain or ordinary income. (citations omitted) And it seems to us that the same principles apply when the statutory provisions regarding installment sales are to be considered.

In the usual installment sale, **allocation** of a portion of the down payment **to specific assets is not required because the relevant percentage of ‘payment’ to ‘selling price’ is the same whether total assets are compared to gross price or specific assets are compared to an allocable portion of the gross price.** An allocation is material, however, when there is a sale . . . with an explicit amount received for property excluded . . . such as . . . the separate agreement for the . . . inventory In such cases it is our conclusion that the sale of inventory for a separate price will not be included in determining whether the ** percent limitation will prevent installment reporting for the sale of other assets. (emphasis added)

40 T.C. 687-688.

Thus, Monaghan does not support Corp F’s argument that, in result, it can have a zero percent profit ratio for some assets and a, say, ** percent profit ratio for the Class VII assets to avoid the ratable basis allocation of § 453. “Divisibility” of the sale only applies for excluded inventory or the 30 percent limitation computation, not to nullify § 453. Williams, above, a 1945 case, also does not moot § 453; rather, said case addresses the question of how the character of the gain is reported – as ordinary or capital income based on the assets involved. See General Counsel Memorandum dated April 19, 1982, GCM 38838, 1982 WL 204258 (IRS-GCM) (§ III, Application of the Mass or Indivisible Asset Concept, interpreting Williams).

Corp F also relies on Robert H. Wellen, Contingent Consideration and Contingent Liabilities in Acquisitions, in Method of Calculating Gain Recognition, in Volume IV 2006, at 9, Chapter 44, (PLI Tax Law and Estate Planning Series Tax Law and Practice Course Handbook Series NO. J-716, 2006). Corp F focuses on § I. C. 4 “Method of Calculating Gain Recognition”. However, said section confirms, in § 1.C.4.c, that under § 453 the seller must recognize gain on each payment using the gross profit ratio, with a proviso on interest reporting. Contrary to Corp F’s interpretation, §1.C.4.d does not assert § 1060 applies to the seller for purposes of trumping § 453 gross profit reporting requirements. Rather § 1.C.4.e notes with a

maximum selling price contingent sale, Temp. Treas. Reg. § 15A.453-1(c)(2)(3) defers basis recovery and accelerates gain. In addition § 1.C.4.e notes that:

In ACM-Partnership v. Commissioner, T.C. Memo 997-115, aff'd 157 F.3d 231 (3rd Cir. 1998), Saga Partnership v. Commissioner, T.C. Memo 1999-359 (1999), ASA Investorings Partnerships v. Commissioner, T.C. Memo 1998-305, aff'd 201 F.3d 505 (D.C. Cir. 2000) and Boca Investorings Partnership v. United States, 314 F.2d 625 (D.C. Cir. 2003), the taxpayers tried to take advantage of the ratable basis recovery under these regulations [and the courts ultimately] found the transaction[s] to be sham[s] in substance. . .

Turning to the specific regulations cited by Corp F, Reg §1.1060-1(c)(1), said regulation provides

[T]he seller's consideration is the amount **in the aggregate**, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, **in the aggregate**, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis. (emphasis added)

No place does this or any other subsection of Reg. § 1.1060 address § 453. No place does this or any other subsection of Reg. § 1.1060 asserts that the sale can be bifurcated into separate sales of each class of assets. Rather, Reg. § 1.1060-1(c)(2) provides that the amount realized for each asset is determined by allocation the consideration to all assets using the residual method under Treas. Reg. §§ 1.338-6 and 1.338-7. Thus, contrary to the contentions of Corp F, the regulations under § 1060 do not support its interpretation of the application of § 453.

For purposes of allocating the aggregate deemed sale price ("ADSP") and adjusted gross-up basis ("AGUP"), Reg. § 1.338-6(a) provides, generally, that fair market value is the gross fair market value without regard to liabilities; it does not define fair market value. Reg. § 1.338-6(b) addresses allocating the consideration (ADSP) among the seven classes of assets, but no where does said regulation address § 453 or infer each asset class is to be treated as a separate, stand alone, sale for purposes of applying § 453. Rather, said regulation provides the total consideration paid is first reduced for Class I Assets (cash and general deposit accounts as further elaborated on in the regulation) then allocated among the other classes of assets in proportion to their fair market value, on an asset class by asset class basis. Asset classes II through VII are defined in Reg. § 1.338-6(b)(2)(ii) through (vii). Reg. § 1.338-6(c) provides that class asset allocations are not to exceed fair market value, again, without defining fair

market value. Fair market value is the amount a hypothetical buyer would pay and a hypothetical seller would accept both being appraised of all relevant facts. Bank One v. Commissioner, 120 T.C. 174, 308-310 (2003) aff'd, in part, vacated in part (on other grounds), remanded in part (on other grounds), (rehearing en banc denied) JPMorgan Chase v. Commissioner 458 F.3d 564 (7th Cir. 2006), decisions re-entered on remand, appeal pending.

Thus, contrary to the contentions of Corp F, Reg. § 1.338-6 does not nullify the temporary regulations promulgated for contingent payment sales subject to § 453 which was specifically amended in Year 5 to mandate ratable basis recovery in contingent payment sales rather than open transaction reporting.

Reg. §1.338-7 addresses situations when there must be a redetermination of ADSP or AGUB, but does not set forth when a redetermination is required other than to refer to general principles of tax law. Said regulation, also, does not modify the reporting under § 453. Moreover, the computation of interest for a contingent payment sale does not fall under this regulation as Reg. §1.338-7(e) makes clear when it states “For rules characterizing deferred contingent payments as principal or interest, see §§ 1.483-4, 1.1274-2(g), and 1.1275-4(c).”

Thus, Corp F errs in its analysis. The proper application of § 453 to the form of the Year 10 transaction is a set forth at the beginning of this Section 3, above.

Section 4 Application of § 483 and § 453A

I.R.C. § 483 applies to a contract for the sale or exchange of property which has a payment more than ** months after the date of the sale, with a payment due more than one year after the sale subject to imputed interest where there is unstated interest. § 483(c). Treas. Reg. § 1.483-4(a) provides § 483 applies to contingent payment sales even if the contract provides for adequate stated interest, with all contingent payments characterized as principal and interest under rules similar to Reg. § 1.1275-4(c)(4).

Corp F should have computed “internal interest” pursuant to the maximum selling price regulations. Corp F must apply the “price-interest computation rule” of Temp. Treas. Reg. § 15A.453-1(c)(2)(ii). The “internal interest:” must be recomputed pursuant to the regulations.

All interest from application of § 483 is ordinary income. The balance of each payment is divided between principal and gain applying the correct gross profit ratio, as addressed in Section 3, above. Thus, the result is that for each payment Corp F must report interest under § 483 and, if the entire payment is not interest, gain, with the gain amount obtained from multiplying the remaining amount of each payment in each Corp

F year by the correct gross profit ratio computed as set forth in the beginning of Section 3, above.²⁹

Given Corp F is a non-dealer and the sales price exceeds \$ ** with each shareholder to receive in excess of \$ ** (§ 453A(B)(2)(B1)),³⁰ the transaction is also subject to the interest imposed by § 453A. Pursuant to § 453A(a)(1), interest must be paid on the deferred tax liability as a surcharge. No regulations have yet been issued on how to apply § 453A in the context of a contingent payment sale. Given there is nothing that keeps the statute open for a “refund” if the sale price is overestimated,³¹ the appropriate computation is to “look back” at the end of each year to compute the interest Corp F must pay.

Section 5 Applicability of § 481

Section 453 prescribes a method of accounting. Corp F and its shareholders failed to qualify for § 453 because there was no sale. Accordingly, its method of accounting failed to clearly reflect income. Pursuant to § 446, the Commissioner can place the taxpayers on a method of accounting that does clearly reflect income. Section 1 of this memorandum sets forth the tax principals that dictate the method of accounting that does clearly reflect income. The Commissioner can and should impose an I.R.C. § 481 adjustment for all income deferred using the installment method from Year 10 through Year 12, for each alternative position. The § 481 adjustment shall be included in income in the Year 13 so that all income that was improperly deferred by reporting income under a method that failed to clearly reflect income is returned to income in Year 13.³²

If the taxpayer continues to assert the transaction constitutes a sale for tax purposes, a § 481 adjustment should be asserted for the alternative position addressed in Sections 3 and 4, above. See Huffman v. Commissioner, 126 T.C. 322, 340-41, 343, 347-48, 350-51, 353-55 (2006) (addressing § 481).

²⁹ While no facts were provided that evidence Corp F is subject to recapture income for amounts which would be treated as §§ 1245 or 1250 ordinary income during its ** month holding period for the investment assets sold to Entity M, if such facts exist, please be aware that the recapture rules of §§ 1245 and 453 override § 453. All recapture income, even if not received, must be recognized in the year of sale. § 453(i).

³⁰ See TAM9853002, Issue 2 (each shareholders’ allocable portion of face amount of \$DD controls applicability).

³¹ See TAM9853002, 1998 WL 908368 (IRS TAM) (no refund allowable based on overstated interest). Thus, a “look back” rule protects from up-front overstated interest.

³² Corp F does not qualify to spread the income adjustment over multiple years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You were requested to make a referral to TEGE, but have not yet made the referral. Please make the referral and provide the TEGE examiner with a copy of this advice. See footnote 1, above (basis for referral).

It is strongly urged that you undertake additional factual development, such as

[REDACTED]

As part of the additional factual development, obtain all information possible on the

[REDACTED]

You should also find out if the form of the transaction was suggested and/or marketed by an accounting or law firm and whether

[REDACTED]

It is imperative that, as an alternative to asserting the primary positions under Section 1, Substance of the Transaction, you assert the proper application of §§ 453, 453A and 483.

[REDACTED]

POSTF-134629-07

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

By: _____
Marjory A. Gilbert
Senior Counsel (Retailers, Food,
Pharmaceuticals & Healthcare)
(Large & Mid-Size Business)

Attachment: Reproduced **, Year 9 Balance Sheet of Corp F.

**CORP F.
UNAUDITED
FINANCIAL STATEMENTS**

BALANCE SHEET

ASSETS	As of **, Year 9
CURRENT ASSETS	
Cash and Cash Equivalents	\$ **
Account Receivable	**
Inventory	**
Deposits and Prepaid Expenses	**
Total Current Assets	**
Property and Equipment – Net	**
Other Assets	**
Total Assets	\$ **
<u>LIABILITIES & EQUITY</u>	
CURRENT LIABILITIES	
Account Payable	\$ **
Accrued Expenses	**
QQ	**
Total Current Liabilities	**
SHAREHOLDER’S EQUITY	
Paid-In-Capital	**
Retained Earnings	(**) <u> </u>
Total Shareholder’s Equity	**
Total Liabilities and Shareholder’s Equity	\$ **

ATTACHMENT ONE TO MEMORANDUM