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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LMSB Group 1, Houston, Area 4

FROM: Income Tax & Accounting
SUBJECT: Disposition of Installment Notes

This Field Service Advice responds to your memorandum. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayer
Target
Installment Notes
a
b
c
Year 1
Year 9
Year 12
Call Date

ISSUE

Whether sellers have "disposed of" installment notes within the meaning of section 453B(a) of the Internal Revenue Code when there has been no modification in either the terms of the note or the rights accruing to sellers under the substituted notes.

CONCLUSION

No disposition occurs on account of the substitution of new installment notes without any other changes, because under the available facts, there is no evidence that the rights accruing to the sellers under the installment sale have either disappeared or been materially altered.

FACTS

Taxpayer is the parent of an affiliated group of corporations that file consolidated life/nonlife federal income tax returns for Year 9 through Year 12. In Year 1, Taxpayer and several of its subsidiaries purchased a certain number of shares of Target with the purpose of obtaining control of Target through a tender offer. Later in the year, Taxpayer and Target reached an agreement under which Taxpayer purchased the stock of Target. Under this purchase agreement, Target shareholders could receive cash, a package of Taxpayer securities, Taxpayer notes (Installment Notes) or a combination thereof.

The Installment Notes contained restrictions on transfer and were meant to be installment obligations under section 453. The Installment notes bore interest of a

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percent and had a maturity of b years, although they were callable by Taxpayer beginning Call Date. Redemption had to be pro-rata among all note holders if there was a redemption of less than all the notes. Taxpayer subsidiaries reported their gain on the installment method.

Both Taxpayer subsidiaries (hereinafter Sellers) as well as other shareholders who were unrelated to Taxpayer elected to take Installment Notes as part of the exchange for their Target stock. When interest rates declined substantially, Taxpayer devised a two part plan to eliminate the high interest rates by redeeming the notes held by outside parties. First, to the holders of Installment Notes who were also Taxpayer subsidiaries, new installment notes were issued in exchange for the old notes. Then, Taxpayer called the Installment Notes held by outside shareholders at a redemption price of c percent. This plan was implemented more than one year after Call Date.

The new notes issued to Taxpayer subsidiaries had the same terms as Installment notes, however, with the redemption of all notes held by unrelated shareholders future redemption was obviously no longer tied to the redemption of any other notes. The Taxpayer subsidiaries applied the installment method to the new notes.

LAW AND ANALYSIS

Section 453 of the Code provides that income from an installment sale shall be taken into account under the installment method. Under the installment method, a portion of the total gross profit from an installment sale is included in income in each year in which the seller receives payment. Section 453B(a) provides that if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange. In short, if an installment obligation is satisfied at its face value or if it is "distributed, transmitted, sold, or otherwise disposed of," the seller must recognize gain or loss at that time.

The issue in this case is whether the Installment Notes were "otherwise disposed of," within the meaning of section 453B, when new installment notes were issued to the Taxpayer subsidiaries. The Commissioner has ruled that certain modifications of the terms of an installment obligation do not amount to a disposition of the obligation. In Rev. Rul. 68-419, 1968-2 C.B. 196, the parties agreed to modify the terms of the note so that each installment of principal due by the original terms of

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the note would be deferred for a period of five years. In addition, the rate of interest was increased from six percent to seven percent per annum. Rev. Rul. 68-419 specifically holds that "the modification of the terms of a purchaser's note (by deferring the dates of payment of principal and increasing the rate of interest) is not a disposition or satisfaction of an installment obligation" within the meaning of section 453(d), the predecessor of current section 453B.

In Rev. Rul. 75-457, 1975-2 C.B. 196, a taxpayer sold real estate to an individual A for cash, a deed of trust, and a promissory note providing for monthly payments over a 15-year term. The terms of the deed and note allowed A to resell the property, provided that the subsequent buyer executed a new note under the same terms and conditions as the original deed of trust. A subsequently sold the property to B, who assumed the obligation by executing a new deed of trust and note in favor of the taxpayer under the same terms and conditions as the original deed of trust and note. A was released from liability on the original note. Rev. Rul. 75-457 holds that the substitution of obligors, deeds of trust, and promissory notes, without any other changes, was not to be considered a satisfaction or disposition of an installment obligation under section 453(d) of the Code. Likewise Rev. Rul. 82-122, 1982-1 C.B. 80, holds that the substitution of a new obligor and a change in the rate of interest will not be considered a satisfaction or disposition of an installment obligation for purposes of section 453B(a).

Hence Service ruling position can be summarized as follows, modification of an installment obligation by changing payment terms, such as increasing the rate of interest or deferring or increasing the payment dates will not constitute a disposition for purposes of the installment sales provisions. Moreover, where the original installment note is replaced, the substitution of a new promissory note without any other changes is not sufficient for the original note to be treated as "disposed of."

Rev. Rul. 75-457, 1975-2 C.B. 196, states that a disposition occurs when the rights accruing to the seller under an installment sale either disappear or are materially altered so that the need for postponing the recognition of gain ceases. We point out that even where there has been a subsequent change in the sales price, the Commissioner has merely required the taxpayer to recompute the gross profit rather than to treat the adjustment as a complete disposition which triggers the recognition of gain. Hence, profit to be reported on an installment sale modified by a reduction in the original sale price is determined by recomputing total gross profit using the adjusted sale price, subtracting profit already reported, and spreading the remainder evenly over installments. Rev. Rul. 72-570, 1972-2 C.B. 241. See also Jerpe v. Commissioner, 45 B.T.A. 199 (1941), Acq. 1942-1 C.B. 9; Rev. Rul. 55-429, 1955-2 C.B. 252.

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The Service has held that the rights of the obligee-taxpayer are materially altered when the parties to the installment note agree to substantially increase the face amount of the note in exchange for the waiver of the taxpayer's right to convert the note into common stock. Rev. Rul. 82-188, 1982-2 C.B. 90. Likewise, in Rev. Rul. 73-423, 1973-2 C.B. 161, where the taxpayer transferred an installment note of the taxpayer's controlled corporation back to the corporation in exchange for stock of the corporation, the Service ruled that there was a disposition within the meaning of the installment sales provisions.

In this case, there is no evidence that there have been any changes to the rights accruing to Taxpayer subsidiaries by virtue of the issuance of the new notes. In fact, the new notes have the identical payment terms so that Taxpayer continued to pay principal and interest to the subsidiaries at the same rate over the original year period. No evidence has been provided indicating that the change in pro-rata redemption rights implicit in the redemption of all notes held by unrelated shareholders had any significant economic impact.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Under these facts, all of the subsidiaries' obligations under the substituted notes are exactly the same as their rights and obligations under the Installment Notes. The result of this series of transactions by the parties was to make a nonpro-rata redemption. While the terms of the Installment Notes specifically require a pro-rata redemption in the event of a redemption of less than all the notes, it is not clear whether this two step approach would constitute a nonpro-rata redemption under the applicable state law. In any event, the failure of Taxpayer to comply with that particular contractual obligation to the noteholders does not, in our view, affect the disposition provisions with respect to section 453B.

Unless the examining agent can establish facts which support a finding that the rights of the subsidiaries have materially altered, we recommend that this issue not be pursued.

Please call if you have any further questions.

By: THOMAS D. MOFFITT
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Income Tax & Accounting Branch 1