Office of Chief Counsel
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date: April 27, 2007

to: Andrew M. Tiktin
(Large and Mid-Size Business)

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subject: Installment Sale/Unrealized Receivables

This Chief Counsel Advice responds to your request for assistance dated March 15, 2007. Specifically, you asked that our office address whether a taxpayer may report income from the sale of the taxpayer's interest in a partnership under the installment method to the extent that it represents income attributable to unrealized receivables for payment for services rendered. In addition, you have asked that if a taxpayer may not report income under the installment method to the extent it represents income attributable to certain unrealized receivables, what is the taxpayer's amount realized from the Note in the year of closing. This advice may not be used or cited as precedent.

ISSUES

1. Whether a taxpayer may report income from the sale of the taxpayer's interest in a partnership under the installment method pursuant to § 453 of the Internal Revenue Code to the extent it represents income attributable to § 751(c)(2) unrealized receivables for payment for services rendered.

2. Assuming that the transaction between the taxpayer and the corporation is a sale or exchange of property for purposes of §§ 483, 1001, and 1274, if the taxpayer may not report income under the installment method to the extent it represents income attributable to certain unrealized receivables, what is the taxpayer's amount realized

from the Note in the year of closing under § 1.1001-1(g) of the Income Tax Regulations.

CONCLUSIONS

1. A taxpayer may not report income from the sale of the taxpayer's interest in a partnership under the installment method pursuant to § 453 to the extent that it represents income attributable to § 751(c)(2) unrealized receivables for payment for services rendered. The taxpayer may report the balance of the income realized from the sale of the partnership interest using the installment method of reporting.

2. Assuming that the transaction between the taxpayer and the corporation is a sale or exchange of property for purposes of §§ 483, 1001, and 1274, as the taxpayer may not report income under the installment method to the extent it represents income attributable to certain unrealized receivables, under § 1.1001-1(g)(1), the taxpayer's amount realized from the Note in the year of closing is its stated principal amount.

FACTS

A taxpayer was a partner in a partnership that held § 751(c)(2) unrealized receivables for payment for services rendered. The taxpayer reports income on the cash method. A corporation purchased the taxpayer's interest in the partnership in exchange for a promissory note (Note) issued by the corporation. The stated principal amount of the Note was greater than $250,000, which was payable on the five-year anniversary of the Note's issue date. The Note also provided for semiannual cash payments of interest each year at a per annum interest rate equal to the semiannual mid-term applicable federal rate (AFR). The Note generally could not be prepaid prior to its stated maturity date. However, the taxpayer had the right to convert all or any portion of the unpaid stated principal amount of the Note into common stock of the corporation any time after the first anniversary of closing. Part of the income the taxpayer realized from the sale was attributable to the partnership's unrealized receivables for services rendered. The taxpayer did not realize any income attributable to a sale of inventory within the meaning of § 751(d).

LAW AND ANALYSIS

Issue 1

Section 453(a) of the Code provides that, except as otherwise provided, income from an installment sale 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 under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

Section 453A(e) of the Code authorizes the Secretary to prescribe regulations necessary to carry out the purpose of section 453A (special rules for nondealers), including regulations providing that the sale of an interest in a partnership will be treated as the sale of the proportionate share of the assets of the partnership.

Section 741 of the Code provides that, in the case of a sale or exchange of a partnership interest, gain or loss recognized to the transferor partner is considered gain or loss from the sale or exchange of a capital asset, except as otherwise provided in § 751.

Section 751(a) of the Code provides that the amount received by a transferor partner in exchange for all or part of a partnership interest shall be considered as an amount realized from the sale or exchange of property other than a capital asset, to the extent such an amount is attributable to unrealized receivables or inventory items of the partnership.

Section 751(c)(2) of the Code provides that the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for services rendered, or to be rendered.

The Service has not issued regulations under § 453 or § 453A to provide expressly that the sale of a partnership interest should be treated as the sale of a proportionate share of the assets of the partnership. However, there is sufficient authority to support the conclusion that a taxpayer may not report income from the sale a partnership interest under the installment method to the extent that the sale represents income attributable to § 751(c)(2) unrealized receivables for payment for services rendered.

Revenue Ruling 89-108, 1989-2 C.B. 100, holds that income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory[1] (within the meaning of § 751(d)), which would not be eligible for the installment sale treatment if sold directly.[2] The balance of the income realized from the sale of the partnership interest may be reported under the installment method. The ruling explains:

> [B]ecause section 751 effectively treats a partner as if the partner had sold an interest in the section 751 property of the partnership, the portion of the gain that is attributable to section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the section 751 property would be reportable under such method.

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[1] The Tax Relief Act of 1997 removed the "substantially appreciated" requirement from § 751(a) and (d).

[2] Revenue Ruling 89-108 specifically provides that the holding is not to be construed as an interpretation of §§ 453(k) and 453A(e).

The ruling further states that "… the installment method is not available for reporting income realized on the sale of a partnership interest to the extent attributable to the substantially appreciated inventory which constitutes inventory within the meaning of section 453(b)(2)(B)."

Based on the reasoning of Rev. Rul. 89-108, to determine if the taxpayer may use the installment method to report income from the sale of a partnership interest to the extent that the income is attributable to certain unrealized receivables, the Service must determine whether income realized on a direct sale of certain unrealized receivables would be reportable under the installment method. While § 453(b)(2)(B) precludes the use of the installment method to report the sale of inventory, judicial authority also supports a conclusion that the installment method may not be used to report the income arising from compensation for services.

The seminal case is *Sorensen v. Commissioner*, 22 T.C. 321 (1954), in which a cash-basis taxpayer entered into an employment arrangement with Willys-Overland Motors (Willys). Willys granted the taxpayer transferable options, exercisable on specified future dates, to purchase stock at a price that was 25% of the then existing market price. Mr. Sorensen continued in Willys' employment but never exercised any of the options. Instead, he sold three of the options prior to their expiration date for cash and notes payable over a number of years.

The Tax Court first determined that the options were granted to Mr. Sorensen as compensation. Mr. Sorensen then argued that he was entitled to report the income from the sale of the options on the installment method. The court disagreed, stating:

> Since the sales of the options operated to compensate petitioner for his services, what he received in the form of both cash and notes was income by way of compensation. The provisions of section 44 [the predecessor of section 453] relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services. Petitioner is not entitled to have them applied here.

Id. at 342.

The Tax Court held that, as the options were granted to Mr. Sorensen as compensation for services, the income from the sale of the options could not be reported as income from the sale of property under the installment method.

This result is further supported by *Hyatt v. Commissioner*, T.C. Memo. 1961-318, *aff'd*, 325 F.2d 715 (5th Cir. 1963), *cert. denied*, 379 U.S. 832 (1964). In 1949, Mr. Hyatt, a cash-basis taxpayer, entered into a general agency contract with United Security Assurance Company (United), a life insurance company, and became United's sole and exclusive agent. At the time of the contract, United did not have any assets or business, and Mr. Hyatt furnished the necessary finances, office, and fixtures to establish the business.

On November 8, 1952, Western American Life Insurance Company (Western) agreed to reinsure certain policies issued by United and agreed to pay United $72,375 under the reinsurance arrangement. Around this same time, United desired to purchase back Mr. Hyatt's agency contract and his related insurance business. Mr. Hyatt was then entitled to substantial income relating to the agency contract. On November 8, 1952, United and Mr. Hyatt entered into a contract that provided that Mr. Hyatt would be assigned the $72,375 receivable owed by Western in exchange for the transfer of the general agency contract to United. Consequently, Mr. Hyatt assigned the agency contract, and the income to which he was then entitled, to United. Western paid Mr. Hyatt $20,000 in 1952 and $52,375 in 1953, and he elected to report the proceeds from the sale on the installment method and reported only the $20,000 received in 1952 on his 1952 income tax return.

The Service asserted that the taxpayer could not use the installment method and that Mr. Hyatt should have recognized the entire $72,375 in 1952. Citing *Sorensen*, the Tax Court agreed stating:

> Inasmuch as the $52,375 amount was a substitute for compensation to Hyatt, . . ., it is clear that the installment sales provisions of section 44(b) [the predecessor of section 453] are inapplicable. *Charles E. Sorensen*, 22 T.C. 321.

As in *Sorensen*, the Tax Court held that income arising from compensation for services could not be reported under the installment method.

In addition, See *Town & Country Food Co. v. Commissioner*, 51 T.C. 1049 (1969), *acq.*, 1969-2 C.B. XXIII (The Tax Court stated that "… clearly the statute [section 453] does not relate to the reporting of income arising from an agreement to render services."); and Rev. Rul. 73-438, 1973-2 C.B. 157 (A taxpayer engaged in selling services cannot use the installment method.).

Therefore, based on the above-cited case law and revenue ruling, a sole proprietor could not report the income realized on the sale of unrealized receivables for services rendered under the installment method. Accordingly, based on the reasoning of Rev. Rul. 89-108 and judicial decisions, a taxpayer may not report income from the sale of a partnership interest under the installment method to the extent that it represents income attributable to § 751(c)(2) unrealized receivables arising from compensation for services. The taxpayer may report the balance of the income realized from the sale of the partnership interest using the installment method of reporting.

Although this advice concludes that income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's § 751(c)(2) unrealized receivables for services rendered, we note that there are some reported cases that hold that the sale of the right to future income or profits is property that can be reported under the installment method. However, these cases do not involve income arising from compensation for services.

First, in *Realty Loan Corp. v. Commissioner*, 54 T.C. 1083 (1970), *aff'd*, 478 F.2d 1049 (9th Cir. 1973), an accrual-basis taxpayer, was a closely-held corporation in the mortgage-banking and mortgage-servicing business. After completing a loan, Realty Loan would assign the note and mortgage to insurance companies. Realty Loan would then service the mortgages as an agent for the insurance companies in exchange for service fees.

In 1962, Realty Loan sold its business for $86,500, plus interest, payable in 60 equal monthly installments. The buyer's principal objective was to obtain Realty Loan's mortgage-servicing contracts. The loans that Realty Loan was servicing on the date of sale were long-term loans of 20 to 30 years. After the sale, the buyer received approximately $40,000 a year in servicing fees from these mortgages. On its 1962 income tax return, the taxpayer reported the sale of its mortgage-servicing business as an installment sale of a capital asset. The Service issued a statutory notice of deficiency, determining that the gain was ordinary income and that the gain could not be reported under the installment method because the gain was not from the sale of property within the scope and meaning of § 453. The Service, thus, took the position that all income must be recognized in 1962.

The Tax Court first held that the sale of the right to future income or profits is property taxable as ordinary income because the property was not a capital asset. Then, the Service relied on *Sorensen* to support its position that the income from the sale could not be reported under the installment sale provisions. However, the Tax Court distinguished *Sorensen* as follows:

> The instant case is factually different from *Charles E. Sorensen*, supra. Had the taxpayer in the *Sorensen* case exercised his options, the entire difference in the price he paid for the stock and its fair market value would have been income to him at that time as compensation for services. When he sold the options he received in effect this same difference in the option price of the stock and its fair market value as compensation. The sale could not change the nature of either that for which it substituted or the time at which the amount was includible in income. In the instant case had petitioner not sold its mortgage-servicing business, it would have received income from the mortgages it was servicing at the date of the sale over a period of approximately 8 years and during these 8 years would have serviced these mortgages. The property petitioner sold . . . was a substitute for its income or profits over a period of years after the sale. The income petitioner sold was not "compensation for services" as in *Sorensen* but rather the future profit to be realized from the rendition of services, which services after the sale were rendered by another.

Id. at 1097-98.

The Tax Court held that since the right to future income is property and the right to future income is not compensation for services, Realty Loan was entitled to report the gain from the sale under the installment method. The Court of Appeals for the Ninth Circuit affirmed the decision and held that mortgage-service contracts that taxpayer sold, which conferred the right to receive future servicing fees, constituted “property” that was eligible for installment sale treatment. The appellant court, in dicta, noted that a strained definition of property was not necessary to prevent the installment sale of rights to receive income that had been previously earned under the taxpayer’s accrual method of accounting. *Supra* at 1051.

Next, in *Foy v. Commissioner*, 84 T.C. 50 (1985), Mr. Foy and others started up and developed a janitorial and building maintenance business, which expanded throughout the United States. Franchises of this business were sold to individuals and partnerships, and Mr. Foy received a profits interest in these franchises.

In 1971, Mr. Foy formed Expansion Enterprises, Inc. (“Expansion”). Mr. Foy was the sole shareholder and president of Expansion. In October 1971, Mr. Foy purportedly transferred his profits interest in various franchises and other related property to Expansion. In July 1976, Mr. Foy and Expansion sold their interest in the franchise network for $290,000. They received cash of $30,000 and a $260,000 note payable over 63 months (with interest). In their written agreement, the parties allocated the purchase price to the “royalty rights” of Mr. Foy and Expansion. The Tax Court found that these royalty rights actually referred to Mr. Foy and Expansion’s profits interest in the franchises.

On their returns, Mr. Foy and Expansion reported the sales as giving rise to capital gains and reported the gains on the installment method. The Service disallowed this treatment, determining that the sales gave rise to ordinary income as compensation for services and could not be reported under the installment method.

The Tax Court first considered whether the amounts received by Mr. Foy and Expansion gave rise to capital gains or ordinary income. The taxpayers contended that their contract rights in the franchise network represented equity interests and were capital assets. The Service countered that the taxpayers only transferred their rights to receive ordinary income. The court held for the taxpayers on this issue, holding that the taxpayers in essence sold their ownership interest in the franchises and their rights to receive a percentage of the profits as part owners, which were capital assets.

The court next considered whether the taxpayers could report the sale under the installment method. It first noted that, under *Sorensen*, if the proceeds were received as compensation for personal services, they could not be reported under the installment method. The court then held:

> Petitioner contends that the transfer in question was a casual sale of personal property and that all four requirements of section 453 are met. Respondent contends that petitioners did not have any "property" to sell, that there was no sale, and that, if there was a sale, the sales proceeds were received as compensation for personal services and cannot be reported under the installment method. We again agree with petitioners. Our holding on the first issue has determined that the petitioners did transfer property, that the transfer constituted a sale and that the sales proceeds were not received as compensation for personal services.

Id. at 74 and 75

The cases of *Realty Loan* and *Foy* are distinguishable from the present situation. In both cases, the Tax Court determined that the right to future income is property and the right to future income is not compensation for services. The Court of Appeals in *Realty Loan* affirmed the lower court decision that the right to receive future servicing fees constituted property eligible for installment sale treatment. The appellant court, however, did not question the compensation for services versus the right to future income distinction made by the Tax Court. The present situation involves the sale of § 751(c)(2) unrealized receivables for services rendered. Thus, under S*orensen* and *Hyatt* and the reasoning of Rev. Rul. 89-108, the income realized from the sale of the partnership interest attributable to the § 751(c)(2) unrealized receivables arising from compensation for services may not be reported under the installment method.

Issue 2

In general, under § 1.1001-1(g)(1) of the Income Tax Regulations, if a debt instrument is issued in exchange for property, the property transferor's amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however, the issue price of the debt instrument is determined under § 1273(b)(4) of the Code, the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under § 483).

If a debt instrument is a contingent payment debt instrument subject to either § 1.483-4 or § 1.1275-4(c), then § 1.1001-1(g)(2) provides a special rule to determine the amount realized attributable to the debt instrument. If the debt instrument is subject to § 1.1275-4(c), the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1274-2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If the debt instrument is subject to § 1.483-4, the amount realized attributable to the debt instrument is the stated principal amount of the debt instrument, reduced by any unstated interest (as determined under § 483), and increased by the fair market value of the contingent payments payable on the debt instrument. Section 1.1001-1(g)(2) does not apply, however, if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable. Section 1.1001-1(g)(2) also does not apply if the income from the exchange is reported under the installment method of § 453.

Under § 1.1001-1(g)(3), if a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of § 453, then § 1.1001-1(g) applies rather than § 15a.453-1(d)(2) to determine the amount realized attributable to the debt instrument.

The Note was not issued for publicly traded property and was not publicly traded within the meaning of § 1.1273-2(f). Therefore, the issue price of the Note is determined under either § 1274 (if the Note does not have adequate stated interest or the Note is issued in a potentially abusive situation) or § 1273(b)(4) (if the Note has adequate stated interest and the interest is qualified stated interest). See § 1.1274-2 to determine whether a debt instrument has adequate stated interest and § 1.1274-3 to determine if a debt instrument is issued in a potentially abusive situation. In either situation, § 1.1274-2(g) provides special rules to determine the issue price of a debt instrument subject to § 1274 that provides for one or more contingent payments. (Based on the facts provided, the Note was not issued in a potentially abusive situation.)

In general, subject to certain exceptions (for example, if the total payments under the debt instrument do not exceed $250,000), if a nonpublicly traded debt instrument is issued for nonpublicly traded property, the debt instrument is tested under § 1274 to determine whether the debt instrument provides for adequate stated interest. In general, if the debt instrument provides for adequate stated interest and all interest payable on the debt instrument is qualified stated interest under § 1.1273-1(c), then § 1274 does not apply to the debt instrument. See § 1274(c)(1) and § 1.1274-1(b)(1). As a result, the issue price of the debt instrument is determined under § 1273(b)(4) (in general, the issue price is the stated principal amount of the debt instrument). (Although § 1274 does not apply to the debt instrument, the debt instrument is not subject to § 483 and retested to determine if the debt instrument has adequate stated interest under § 483.)

Although it is not clear from the terms of the Note if the stated interest payable on the Note each year is the mid-term AFR as of the month the Note was issued or the mid-term AFR for each six-month accrual period (that is, the interest rate resets every six months), in either case, the stated interest rate is at least equal to the test rate under § 1.1274-4. Therefore, the Note has adequate stated interest under § 1274 and § 1.1274-2(c).

In general, under § 1.1273-1(c), qualified stated interest is stated interest that is unconditionally payable in cash at least annually at a single fixed rate (or at a single qualified floating rate under § 1.1275-5). Under § 1.1273-1(c)(1)(ii), an option to convert a debt instrument into stock of the issuer is ignored for purposes of determining whether interest is unconditionally payable. The stated interest on the Note is payable semiannually each year. Also, under the terms of the Note, the failure to pay interest within 10 days of its due date is an event of default upon which the holder can declare the entire debt (principal and interest) due immediately. This right makes the stated interest unconditionally payable within the meaning of § 1.1273-1(c). See Rev. Rul. 95-70, 1995-2 C.B. 124. Therefore, the stated interest on the Note is qualified stated interest under § 1.1273-1(c).

Because the Note provides for adequate stated interest and all stated interest payable on the Note is qualified stated interest, the issue price of the Note is not determined under § 1274. Instead, the issue price of the Note is its stated redemption price at maturity under § 1273(b)(4). See § 1.1273-2(d)(1). Because the stated interest on the Note is qualified stated interest, the Note's stated redemption price at maturity and, therefore, its issue price, is its stated principal amount. See § 1.1273-1(b) for the definition of the term "stated redemption price at maturity."

Under § 1.1275-4(a)(4), a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into stock of the issuer, into the stock or debt of a related party (within the meaning of § 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt. The Note provides the taxpayer with the option to convert the Note into stock of the issuer (the corporation) at any time on or after the first anniversary of closing. Because the Note's conversion option is described in § 1.1275-4(a)(4) and because the Note does not provide for any other payments that are contingent payments within the meaning of § 1.1275-4, the Note does not provide for contingent payments and, therefore, is not subject to § 1.1275-4. Moreover, the issue price of the Note is not determined under § 1.1274-2(g) (special rule to determine the issue price of a debt instrument that provides for one or more contingent payments under § 1274).

In general, § 1.483-4 applies to a contract for the sale or exchange of property (including a contract that is a debt instrument) if the contract provides for one or more contingent payments and the contract is subject to § 483. Section 1.483-4 applies even if the contract provides for adequate stated interest. If §1.483-4 applies to a contract, then interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275-4(c). For purposes of § 1.1275-4(c), a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into stock of the issuer. See § 1.1275-4(a)(4). Therefore, for purposes of § 1.483-4, a contract does not provide for contingent payments merely because it provides for an option to convert the debt instrument into stock of the issuer. As explained above, the Note is not subject to § 483. However, even if it were subject to § 483, the Note does not provide for contingent payments because of the conversion option. The rules to determine whether a payment is contingent for purposes of § 1.483-4 are the same as the rules for purposes of § 1.1275-4 and, as explained above, the conversion option does not result in the Note having contingent payments. Therefore, § 1.483-4 does not apply to the Note. (If the conversion option did result in the Note having contingent payments for purposes of § 1.1275-4 (or § 1.483-4), then all payments on the Note after the first anniversary of closing would be contingent because the conversion option could be exercised at any time after that date.)

Accordingly, based on the assumption that the transaction between the taxpayer and the corporation is a sale or exchange of property for purposes of §§ 483, 1001, and 1274, the issue price of the Note is its stated principal amount under § 1.1273-2(d)(1) and § 1273(b)(4). The Note's conversion option does not result in any contingent payments on the Note and, therefore, neither § 1.483-4 nor § 1.1275-4 applies to the Note. Under § 1.1001-1(g)(1), the taxpayer's amount realized from the Note in the year of closing is its stated principal amount.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

A taxpayer may argue that the sale of a partnership interest need not be fragmented for purposes of the installment sale provisions in the absence of regulations. However, we think that Rev. Rul. 89-108 and case law provides sufficient authority to support the conclusion that a taxpayer may not report income from the sale of the taxpayer's interest in a partnership under the installment method pursuant to § 453 to the extent that it represents income attributable to § 751(c)(2) unrealized receivables for payment for services rendered. In addition, a taxpayer might challenge the underpinnings of Rev. Rul. 89-108.[3]

[3] Secondary authority suggests that fragmentation of partnership interests may be appropriate for purposes of applying the installment sale provisions. *See* William S. McKee, William F. Nelson, Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 15.04[1][b]; ¶ 16.05[1] (3d ed. 2004). *But compare*, Monte A. Jackel, *Installment Sale of Partnership Interests: Aggregate or Entity?* 69 Tax Notes 363 (Oct. 16, 1995).