Internal Revenue Service

Number: **200728039**
Release Date: 7/13/2007

Index Number: 453.09-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B05
PLR-155713-06
Date:
April 4, 2007

Legend:

Adjustment =

Buyer

Company =

Guarantor

Purchase Price

Date 1

q

r

s

t

Dear :

This is in response to your request for a private letter ruling under section 453 of the Internal Revenue Code and section 15A.453-1(c)(7)(ii) of the Temporary Income Tax Regulations. Section 15A.453-1(c)(7)(ii) provides for use of an alternative method of basis recovery in circumstances involving contingent payment installment sales of property where use of the general rules provided in the Code and regulations would inappropriately defer recovery of a taxpayer's basis in the property sold.

FACTS:

On Date 1, the Company, an S corporation, entered into an asset purchase agreement with the Buyer, a directly or indirectly wholly-owned subsidiary of the Guarantor, pursuant to which the Company agreed to sell to the Buyer substantially all of the assets used in the Company's business (the “Purchase Agreement”).

Under the terms of the Purchase Agreement, the Buyer agreed to pay the Company (i) the Purchase Price, (ii) the Adjustment, and (iii) two contingent earn out payments to be determined as a multiple of the amount by which annualized EBITDA exceeded a threshold amount throughout specified periods subsequent to the sale. For purposes of the Purchase Agreement, EBITDA is defined as the net income of the Buyer and all of its subsidiaries plus depreciation, amortization, the excess of interest expense over interest income, and income taxes. The Buyer also agreed to assume certain liabilities of the Company.

At the closing, the Buyer paid "q" percent of the sum of the Purchase Price and the Adjustment to the Company. The remaining "r" percent of the Purchase Price and the Adjustment was deposited in an escrow account to secure the Company's obligations under the Purchase Agreement to indemnify the Buyer against certain liabilities that might arise in connection with the Purchase Agreement. The escrow account will terminate two years after the date of the escrow agreement. On termination, the remaining balance in the escrow account (after payment of any fees then owing to the escrow agent), less the aggregate amount of any indemnification claims that have not been either (i) paid in accordance with the terms of the escrow agreement or (ii) rejected, denied or withdrawn in accordance with the terms of the

escrow agreement, shall be paid to the Company. Any funds that continue to be held by the escrow agent after the termination date for the escrow account with respect to an indemnification claim shall be paid to Buyer or the Company when and as the indemnification claim is resolved in accordance with the terms of the escrow agreement, in a manner consistent with such resolution.

Based on the information provided, the average EBITDA of the Company for the five years preceding the sale was $t. It would be necessary for EBITDA to increase by approximately 65 percent before the Company would incur a liability for a contingent earnout payment. Based on the information provided, if the circumstances existing from the closing through the end of the year of sale were annualized to the end of the period to be used for determining the first contingent payment, the Buyer would not incur a liability for a contingent payment. It has been represented that the increase in EBITDA for the period from the date of closing through the end of the year of sale was attributable to a number of factors, including: price increases for the Company's products and one-time cost and expense reductions (including the elimination of certain officer salaries, the reduction of bonuses for officers, and the elimination of auto expenses of officers). It has also been represented that the Company will not be able to implement price increases, similar in magnitude to those implemented after the closing, in the foreseeable future. The utilization rate of the Company's facilities and the size of the Company's workforce have remained essentially unchanged and are not expected to change. The expense reductions implemented between the closing and December 31, 2006, are not expected to yield subsequent year savings in excess of the annualized savings realized during the taxable year that ended December 31, 2006.

Under the Company's proposed alternative method of basis recovery, the amount of basis allocated to an installment payment would bear the same ratio to the Company's total basis in the property sold that the installment payment bears to the estimated amount of the aggregate payments to be received by the Company during the term of the installment obligation. The estimated amount of the aggregate payments to be received would by the sum of "q" percent of the Purchase Price and the Adjustment received in the year of sale and the balance in the escrow account which is to be paid to the Company two years after the creation of the escrow account. The estimated amount of the payments to be received includes no amount for either of the two contingent earnout payments as the Company does not expect to receive any earnout payments.

LAW AND ANALYSIS:

Section 453(a) of the Code provides as a general rule that, except as otherwise provided in that section, income from an installment sale shall be taken into account under the installment method for federal income tax purposes.

Section 453(b)(1) of the Code defines the term "installment sale" as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453(c) of the Code defines "installment method" as a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

Section 453(j)(2) of the Code provides that the Secretary of the Treasury shall prescribe regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot readily be ascertained.

Section 15A.453-1(c)(1) of the Income Tax Regulations defines the term "contingent payment sale" as a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale or other disposition occurs. The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transaction, regardless of the existence of a stated maximum selling price or fixed payment terms.

Section 15A.453-1(c) provides rules for allocating a taxpayer's basis to payments received and to be received in a contingent payment sale. The rules distinguish between contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable.

Section 15A.453-1(c)(3)(j) provides that when a stated maximum selling price cannot be determined as of the close of the taxable year in which a sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sales price agreement is fixed, the taxpayers basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.

Section 15A.453-1(c)(7)(ii) provides that a taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate, prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rules will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rules will substantially and inappropriately defer recovery of basis, the taxpayer must show:

> (1) that the alternative method is a reasonable method of ratably recovering basis; and
>
> (2) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule.

In addition, section 15A.453-1(c)(7)(ii) provides guidelines as to what type of data is acceptable in demonstrating that application of the normal basis recovery rules would substantially and inappropriately defer recovery of the taxpayer's basis. The section provides that the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profits, or other factual data that are subject to verification. The section further provides that the taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances, a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred.

CONCLUSION:

Based on the information submitted and the representations made, we conclude that application of the normal basis recovery rule of section 15A.453-1(c)(3) would substantially and inappropriately defer recovery of the Company's basis in the property sold and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate at least twice as fast as the rate at which basis would be recovered under the normal basis recovery rules. The proposed alternative method of basis recovery represents a reasonable method of basis recovery. Accordingly, the Company's use of the proposed alternative method of basis recovery is approved.

Section 453A imposes an interest charge on tax that is deferred through the use of the installment method if, at the close of the taxable year, the taxpayer holds installment obligations which arose during the year and are outstanding as of the close of the year with a face amount that exceeds $5,000,000. In circumstances involving an S corporation, section 453A is applied at the shareholder level. For purposes of determining whether and to what extent any of the shareholders of the Company will incur a liability for the interest charge imposed by section 453A, the amount of any earnout payments the Company receives shall be taken into account by the Company's shareholders, in their taxable year with, or within, which the Company's tax year ends.

For purposes of determining a shareholder's liability for section 453A interest, the amount of an earnout payment shall be treated as the face amount of a fixed amount installment obligation outstanding as of the end of the shareholders' taxable year with

which, or within which, the Company's taxable year in which the sale took place ends. If a shareholder is liable for section 453A interest, the amount of section 453A interest shall be determined for each year during the period beginning with the shareholder's return for the year with which, or within which, the Company's year in which the sale took place ends and ending with the shareholder's return for the year prior to the year with which, or within which, the Company's year in which the earnout payment is received ends. The amounts so determined plus interest thereon at the underpayment rate in effect under section 6621(a)(2) for the respective periods described above shall be reported and paid with the shareholder's return for the respective period.

CAVEATS:

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. A copy of the letter is enclosed. Also enclosed is a copy of the ruling letter with the deletions proposed to be made when the letter is subject to disclosure under section 6110.

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosure
Copy of this letter
Copy of letter with proposed deletions

cc: