Internal Revenue Service

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LEGEND

Taxpayer	=
Trust	=
Year 1	=
Trustee	=
Partnership 1	=
Partnership 2	=
Partnership 3	=
Partnership 4	=
Individual 1	=
Individual 2	=
x	=
z	=

Dear :

This is in reply to your letter requesting a letter ruling concerning the proper income tax treatment of the sale of real estate under § 453 of the Internal Revenue Code.

FACTS

Taxpayer, an individual, files his federal income tax return on a calendar year basis and uses the cash method of accounting. Taxpayer owns various interests in improved residential and commercial real estate, but has not sold any real estate for several years.

Trust was formed in Year 1 to invest in real estate. Trust, however, does not currently own any assets. Trust has elected to be taxed as a corporation for federal income tax purposes and has filed Form 1120, *U.S. Corporation Income Tax Return*, for Year 1.

Trustee, an individual, is a licensed realtor, owns various investments in improved real estate, and is experienced in financial investments matters. Trustee owns 100 percent of the outstanding beneficial interest of Trust.
Taxpayer and Trustee, as individuals, are not members of the same family, nor do they have any legal or blood relationship. However, Taxpayer and Trustee are each 50 percent partners in three partnerships, Partnership 1, Partnership 2 and Partnership 3. Taxpayer, Trustee, Individual 1 and Individual 2 are each 25 percent partners in Partnership 4. Trustee and Individual 1 are brothers.

Partnership 4 is a limited liability company and is a disregarded entity under § 761(a) of the Code. Partnership 4 owns one asset, a commercial real estate building, which generates rental income. Partnership 4's depreciation deductions have been limited to the straight-line method of adjustment.

Taxpayer intends to sell his 25 percent interest in Partnership 4 to Trust and to report the gain under the installment method pursuant to § 453. Trust will issue a promissory note with an initial principal balance of $x. The promissory note bears adequate stated interest and the Trust will make monthly interest payments to Taxpayer with the principal balance due in a single balloon payment at the end of z years. With the exception of cash held by Trust, Taxpayer will retain a security interest in all of the assets of Trust including the membership shares of Partnership 4. Trust is not a creditor of Taxpayer and will not be a creditor of Taxpayer after Taxpayer sells his interest in Partnership 4. For federal income tax purposes, Taxpayer's sale of its 25 percent interest in Partnership 4 is treated as a sale of Taxpayer's 25 percent interest in the commercial real estate building.

Trust may sell the membership shares of Partnership 4 or the underlying commercial real estate within two years after the date of the installment sale.

RULINGS REQUESTED

1. Whether the related party rule described in § 453(e) of the Code will apply, thereby causing the recognition of gain by Taxpayer on a second disposition of the membership shares of Partnership 4 by Trust.

2. Whether § 453(g) of the Code will preclude the use of the installment method by Taxpayer as the result of a sale of depreciable property to a controlled entity.

3. When will Taxpayer recognize depreciation deductions previously taken as unrecaptured § 1250 gain as the result of the installment sale of Taxpayer's membership shares in Partnership 4.

LAW AND ANALYSIS

Issue 1

Section 453(a) provides, in general, that income from an installment sale shall be taken into account under the installment method. Section 453(e) provides, in part, that if any person disposes of property to a related person (hereinafter in this subsection referred to as the “first disposition”), and before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the “second disposition”), then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition. Section 453(f)(1), defines the term “related person” as a person whose stock would be attributed under § 318(a) (other than paragraph (4) thereof) to the person first disposing of the property, or a person who bears a relationship described in § 267(b) to the person first disposing of the property.

Section 267(b)(2) provides that related persons include an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.

Section 267(c)(1) provides that for purposes of determining the ownership of stock in applying subsection (b), the ownership of stock owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

Section 267(c)(3) provides that an individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

Section 1.267(c)-1(a)(2) of the Income Tax Regulations provides, in part, that for an individual to be considered under § 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under § 267(c)(1), by or for his partner, such individual must himself actually own, or constructively own under § 267(c)(1), stock of such corporation.

In this case, Taxpayer and Trust are not related parties for purposes of § 267(b).

Additionally, Taxpayer represents that Trustee is not a related person whose stock in Trust would be attributed under § 318(a) (other than in § 318(a)(4)) to Taxpayer in the first disposition, or a related person who bears a relationship described in § 267(b) to Taxpayer in the first disposition.

For the reasons stated above, Taxpayer and Trust are not related within the meaning of § 267(b) and Taxpayer shall not be considered as owning the stock of Trust owned by Trustee pursuant to § 318(a).

Issue 2

Section 453(g)(1)(A) provides that in the case of an installment sale of depreciable property between related persons § 453(a) shall not apply.
Section 453(g)(3) provides that for purposes of § 453(g), the term "related persons" has the meaning given to such term by § 1239(b), except that such term shall include 2 or more partnerships having a relationship to each other described in § 707(b)(1)(B).

Section 1239(b), in relevant part, provides, that for purposes of § 1239(a), the term "related person" means a person and all entities which are controlled entities with respect to such person.

Section 1239(c)(1) provides that the term "controlled entity" means, with respect to any person (A) a corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person, (B) a partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and (C) any entity which is a related person to such person under paragraph (3), (10), (11) or (12) of § 267(b).

Section 1239(c)(2) provides that for purposes of § 1239, ownership shall be determined in accordance with rules similar to the rules under § 267(c) (other than paragraph (3) thereof).

In this case, Taxpayer and Trust are not related parties for purposes of § 1239(b). In addition, Taxpayer and Trust are not in a relationship described in § 707(b)(1)(B).

Issue 3

Section 453(i)(1) of the Code provides, in part, that in the case of any installment sale of property to which § 453(a) applies, any recapture income shall be recognized in the year of the disposition, and any gain in excess of the recapture income shall be taken into account under the installment method. For this purpose, § 453(i)(2) states that the term "recapture income" means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under § 1245 or 1250 for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition.

Section 1.453-12(a) of the regulations provides that unrecaptured § 1250 gain, as defined in § 1(h)(6), is reported on the installment method if that method otherwise applies under § 453 or 453A and the corresponding regulations. If gain from an installment sale includes unrecaptured § 1250 gain and adjusted net capital gain (as defined in § 1(h)(3)), the unrecaptured § 1250 gain is taken into account before the adjusted net capital gain.

Section 1250(a)(1)(A) provides, in part, that if § 1250 property is disposed of after December 31, 1975, the applicable percentage of the lower of (i) that portion of the additional depreciation (as defined in § 1250(b)(1)) attributable to periods after December 31, 1975, in respect of the property or (ii) the excess of the amount realized on the sale of the property over its adjusted basis shall be treated as gain which is ordinary income.

Section 1250(b)(1) provides that the term "additional depreciation" means, in the case of any property, the depreciation adjustments in respect of such property, except that, in the case of any property held more than one year, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under a straight-line method of adjustment.

Section 1(h)(6) of the Code provides that the term "unrecaptured § 1250 gain" means the excess (if any) of the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if § 1250(b)(1) included all depreciation and the applicable percentage under § 1250(a) were 100 percent, reduced by any net loss in the 28 percent rate category.

As mentioned above, § 453(i)(1) of the Code provides that in any installment sale of property under § 453(a), any recapture income will be recognized in the year of sale, and any gain in excess of the recapture income will be taken into account under the installment method. In general, the term "recapture income" means the amount treated as ordinary income under § 1250 for the year of disposition. Section 1250(a)(1) provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income. In this case, Partnership 4's depreciation deductions have been limited to the straight-line method of adjustment. Therefore, there is no recapture income to be recognized in the year of sale under § 1250.

Under § 1(h)(6) and § 1250(b)(1) of the Code, however, a taxpayer must take into account unrecaptured § 1250 gain. In general, § 1(h)(6) defines the term "unrecaptured § 1250 gain" as equal to the amount of straight-line depreciation allowed for the property. The amount of unrecaptured § 1250 gain from § 1231 assets is limited, however, to the net § 1231 gain for the taxable year. Therefore, Taxpayer will recognize 100 percent of the unrecaptured § 1250 gain to the extent § 1231 gain exists in each tax year attributable to the sale. Section 1.453-12 of the regulations provides that if gain from an installment sale includes unrecaptured § 1250 gain and adjusted net capital gain, the unrecaptured § 1250 gain is taken into account before the adjusted net capital gain.

CONCLUSIONS

1. The related party provisions described in § 453(e)(1) of the Code do not apply. Therefore, Taxpayer will not recognize gain on a second disposition of the membership shares of Partnership 4 by Trustee.

2. Section 453(g) of the Code will not preclude the use of the installment method by Taxpayer.

3. Taxpayer will recognize 100 percent of the unrecaptured § 1250 gain to the extent § 1231 gain exists in each tax year Taxpayer receives payments on the sale of Partnership 4. Section 1.453-12 of the regulations provides that if gain from an installment sale includes unrecaptured § 1250 gain and adjusted net capital gain, the unrecaptured § 1250 gain is taken into account before the adjusted net capital gain.

CAVEATS

Except as expressly provided in Conclusions 1, 2, and 3, above, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no facts were provided, and therefore no opinion is expressed regarding whether Taxpayer is an individual specifically described in § 318(a)(1).

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.

A copy of this letter must be attached to any income tax return to which it is relevant. Taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)