Internal Revenue Service

Department of the Treasury

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Legend:
Counsel 1 =
Counsel 2 =
Counsel 3 =

Counsel 4 =
CPA =
M =
N =
Taxpayer =

TPB =
W Corp =
X Corp =
Y Corp =
Date 1 =
Date 2 =
Date 3 =
Month 1 =
Month 2 =
Month 3 =
Month 4 =
Month 5 =
Month 6 =
b =
c =
d =
e =
f = $
g =
h = $
i = $
j = %
k =
l =

m =

Dear :

This is in response to a request for ruling submitted on your behalf concerning the application of section 453(d) of the Internal Revenue Code with respect to the sale of stock of Y Corp described herein.

As of the beginning of Month 1, Taxpayer and TPB owned m percent of the stock of X Corp. Taxpayer was interested in selling some or all of the X Corp stock as he desired to diversify his investment and retire from the operation of the business carried on by X Corp. On Date 1, following extensive due diligence and discussions with the management of X Corp, W Corp announced that it had terminated an option to purchase X Corp.

During the month following the termination of negotiations between W Corp and X Corp, M, who had worked for X Corp for several years, and N, who had worked for an entity which had previously considered acquiring X Corp, approached Taxpayer with a proposal for the sale of X Corp. Under the proposed terms, the stock of X Corp would be transferred to Y Corp, a public shell corporation listed on NASDAQ (National Association of Securities Dealers Automated Quotations) in exchange for stock of Y Corp. Prior to the stock exchange, Taxpayer would grant M and N options to purchase b and c shares, respectively, of the stock of the Company (the Acquisition Agreement refers to X Corp and Y Corp, collectively, as the Company). TPB was to grant M and N options to purchase d and e shares, respectively, of the Company. The options, which would allow M and N to purchase shares of the Company at a price of $f per share, would have a two year term and would only be exercisable for cash.

On Date 2, Taxpayer and TPB executed Acquisition Agreements which granted M and N each the right to purchase the specified number of shares of stock of the Company. On Date 3, the stock of X Corp was transferred to Y Corp in exchange for a specified number of shares of Y Corp stock in a transaction which was represented to have qualified as a non-taxable reorganization. The name of Y Corp was subsequently changed to that previously used by X Corp.

All of the Y Corp stock which Taxpayer received in exchange for his X Corp stock was unregistered. Taxpayer had no demand or piggyback rights to either require Y Corp to register the shares he held or to include those shares in a registration of Y Corp stock which was to be publicly offered. Taxpayer also granted Y Corp the right to request that he withhold the sale of any of his Y Corp stock during a period beginning seven days prior to Y Corp's filing of a final prospectus and ending 180 days after such date. Y Corp filed a final prospectus during Month 2.

Prior to Month 3, M and N each acquired some shares of Y Corp under the terms of the options. A short time before the expiration of the options in Month 3, M and N

advised Taxpayer that they had been unable to obtain financing to acquire the remaining shares subject to the options. The options required cash settlement. M and N did obtain sufficient financing to exercise the options TPB had granted them. At the time, Y Corp stock was trading at a price more than double the exercise price of the options. M and N asked Taxpayer to waive the option requirement for cash settlement and accept their promissory notes in payment for the stock subject to the options. They suggested that, as members of the management of Y Corp, their failure to exercise the options would be interpreted as a vote of no confidence by management that would adversely affect the market price of Y Corp's publicly traded stock.

Before agreeing to accept notes from M and N, Taxpayer had Counsel 1 review the proposed notes. Counsel 1 advised Taxpayer that his sale of Y Corp stock could be reported on the installment method. However, approximately two weeks before the sale of the stock, Counsel 1 reversed his position with respect to the availability of the installment method. The reversal was attributed to research by the CPA and discussions between the CPA and Counsel 1. These advisers believed Taxpayer could not report the sale on the installment method because the Y Corp stock was unregistered stock of a publicly traded corporation, and the M and N notes were payable on demand of Taxpayer.

Taxpayer accepted M and N's notes in payment for the Y Corp stock. The notes provided fore interest at the rate of j percent per year. The initial principal and interest payment on the notes was due during Month 4, four months after the date of sale and in the subsequent year. The remaining principal and interest was due on the first anniversary of the initial payment, or upon the holder's written demand, whichever occurred first. As collateral for the notes, Taxpayer required M and N to escrow a number of Y Corp shares with a market value which approximated the aggregate face amount of their notes. Y Corp stock traded in a range between $h and $i during the two month period beginning with the month preceding the month in which the sale of stock occurred. Based on the market price of Y Corp stock relative to the exercise price of the options, the number of shares required as collateral was approximately one-third the number of shares M and N acquired upon exercise of the options.

After the sale of the Y Corp stock but before preparing Taxpayer's return for the year of sale, the CPA discovered that the Internal Revenue Service had issued a number of private letter rulings which approved the use of the installment method to report the sale of unregistered stock of publicly traded corporations. Upon learning of those private letter rulings, the CPA performed additional research concerning the characterization of the notes as demand notes but was unable to find sufficient authority to cause him to change his opinion that the demand feature of the notes precluded the use of the installment method.

In accordance with the advice of the CPA and Counsel, Taxpayer included the face amount of the notes received from M and N in determining the gain from the sale of Y Corp stock reported on the joint federal income tax return filed by Taxpayer for the

year of sale.

M and N made timely payment of the first scheduled payment on their respective notes. At the time of those payments, the market price of Y Corp stock had declined from the level it was at when they exercised the options to purchase Y Corp stock. The market price was still a multiple of the per share cost of the stock M and N acquired by exercising the options. However, the decline in the market price of Y Corp stock caused Taxpayer to be concerned that the collateral for M and N's notes might be inadequate. He retained Counsel 2 to consider whether applicable securities laws would restrict or preclude sale of the Y Corp stock provided as collateral for M and N's notes if a demand for immediate payment of the balance of the notes were not satisfied. Counsel 2 advised Taxpayer to resign as Chairman of Y Corp to end his "affiliate" status under 17 CFR 230.144. In addition to securities law considerations, Taxpayer was concerned that an attempt to sell the collateral might further depress the market price of Y Corp stock.

Taxpayer, Taxpayer's counsel at the time, and the CPA initiated negotiations with M and N in an attempt to secure additional collateral for the notes. On a number of occasions subsequent to the first payment on the notes in Month 4, M and N verbally agreed to provide additional Y Corp shares as collateral but failed to deliver the shares. They also represented that sale of Y Corp was imminent. A few months before the second payment was due, Taxpayer sent M and N letters outlining conditions for further negotiations. The conditions were ultimately rejected. M and N subsequently failed to pay the balance on their respective notes when due in Month 5.

After the default on the notes, Taxpayer sought legal advice from an attorney who practices in the area of creditors rights, in another office of Counsel 2. Taxpayer, the CPA, and the attorney negotiated with M and N in an attempt to obtain additional shares of Y Corp stock as additional collateral for their debt. After negotiations proved unsuccessful, the attorney drafted a demand notice which Taxpayer sent to M and N during Month 6.

Shortly thereafter, Taxpayer concluded that he would be forced to file suit and retained Counsel 3 for that purpose. At the same time, materials were also sent to Counsel 4 for review and advice. During discussion of the history of M and N's notes with Counsel 3, Counsel 3 was asked to prepare an opinion concerning the demand feature of the notes and the characterization of the notes as demand notes. The opinion indicated that, under applicable state law, neither of the notes of M nor N was due, in whole or in part, whether payment was demanded or not, prior to the date of the first scheduled payment, four months after the execution of the notes. In a subsequent review of the notes, Counsel 4 concurred in Counsel 3's analysis of the notes under applicable state law.

If the Y Corp shares sold by Taxpayer were not treated as stock traded on an established securities market and M and N's notes were not demand notes, Taxpayer's

sale of Y Corp would have qualified for reporting under the installment method. Based on that information, Taxpayer initiated action to modify the manner in which he reported the sale of stock on the Form 1040 filed by the Taxpayer for the year of sale.

Section 453(a) of the Code provides that income from an installment sale shall be taken into account under the installment method.

Section 453(c) provides, in part, that for purposes of that section, the term "installment method" means 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(f)(4) provides, in part, that receipt of a bond or other evidence of indebtedness which is payable on demand shall be treated as receipt of payment.

Section 15a.453-1(e)(1) of the Income Tax Regulations provides, in part, that a bond or other evidence of indebtedness issued by any person and payable on demand shall be treated as a payment in the year received, not as an installment obligation payable in future years.

Section 15a.453-1(e)(3) provides that an obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

Section 453(k)(2)(A) provides, in part, that section 453(a)(1) shall not apply in the case of any installment obligation arising out of a sale of stock or securities which are traded on an established securities market, and all payments to be received shall be treated as received in the year of disposition.

Section 453(d)(1) of the Code provides that section 453(a) shall not apply to any sale if the taxpayer elects not to have section 453(a) apply to the sale.

Section 453(d)(3) provides that an election made with respect to any disposition may be revoked only with the consent of the Secretary.

Section 15a.453-1(d)(4) of the Income Tax Regulations provides that, generally, an election out of section 453 is irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. A revocation is retroactive. A revocation will not be permitted when one of its purposes is the avoidance of federal income taxes, or when the taxable year in which any payment was received has closed.

> A taxpayer will not be permitted to revoke an election out of the installment method merely because the benefit of hindsight indicates that a revocation of an election would be beneficial. Hindsight includes those situations where the taxpayer's desire to revoke an election out is prompted by changed

circumstances, subsequent events, or occurrences beyond the taxpayer's control.

However, there are situations in which the Service will allow a taxpayer to revoke its election out of the installment method. In those situations, the facts reflect that (1) the taxpayer originally intended to report the disposition on the installment method; (2) the taxpayer's request to use the installment method was frustrated by inadvertent errors of third persons; (3) the taxpayer acted diligently in requesting a revocation; and (4) the requested revocation did not prejudice the interest of the government.

Before addressing the request for approval for revocation of the election out of the installment method, it is necessary to decide whether section 453(k)(2)(A) or section 453(f)(4) precluded the use of the installment method with respect to Taxpayer's sale of the Y Corp stock sold to M and N. If the use of the installment method was precluded, the request to revoke an election out of the installment method would be moot.

Congress enacted the installment method to provide relief for taxpayers who were required to pay tax on the entire gain in the year they sold property on an installment basis although they may have received only a small portion of the sales price during such year. S. Rep. No. 69-52, 69th Cong., 1st Sess. 19 (1926). See also Commissioner v. South Texas Lumber Co., 333 U.S. 496, 503 (1947).

At the time the Installment Sales Revision Act of 1980 was enacted, the Senate Finance Committee indicated that the installment method is intended to permit the spreading of income tax on the sale of property over the period during which payments of the sales price are received. "The installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not actually been received." S. Rep. No. 96-1000, 96th Cong., 1st Sess. 7 (1980).

When Congress added section 453(k)(2) in 1986, it indicated that the installment method should not be available for sales of publicly traded property because such property is considered to be sufficiently liquid to be treated the same as a payment for cash for purposes of applying the installment method. Publicly traded property does not present the same liquidity problem the installment method is intended to alleviate since a taxpayer can easily sell such property for cash in the public market. S. Rep. No. 99-313, 99th Cong., 2nd Sess. 124.

Although the Y Corp stock in this case generally was publicly traded on an established securities market, the Y Corp stock held by Taxpayer was unregistered, and thus was restricted from sale to the public under federal securities laws. In enacting section 453(k)(2)(A), Congress determined that the installment method should not be available to a taxpayer who accepts an installment note for the sale of publicly traded property. Such property can easily be sold for cash in a public market and does

not present the liquidity problem the installment method was intended to mitigate. In effect, Congress felt that the installment method was not warranted for a taxpayer who has the option of selling property in a public market for cash. In this case, however, Taxpayer is precluded from selling the Y Corp stock in a public market and cannot pick and choose between selling the stock for cash or notes. Under these circumstances, application of section 453(k)(2)(A) would not be appropriate, and Taxpayer's use of the installment method would not be precluded on this basis.

With respect to whether the M and N notes were payable on demand, Taxpayer has provided two opinions of counsel concluding that Taxpayer's demand privilege did not extend to the initial payments due under the notes, and thus under applicable state law the notes were not payable on demand in the year of sale. Consequently, Taxpayer's receipt of the notes in the year of sale of the Y Corp stock will not be treated as the receipt of payment in that year for purposes of section 453(f)(4). Accordingly, Taxpayer is not precluded from using the installment method for this reason either.

The inclusion of the face amount of the notes in determining the amount of the gain reported on the joint return filed by Taxpayer was based on advice received from the CPA and Counsel 1. It has been represented that Taxpayer received no tax benefit, e.g., offset of capital loss, deduction of investment interest by electing to treat a portion of the gain on the Y Corp stock as investment income, etc., as a result of reporting the entire gain on the Y Corp stock sold to M and N on the federal income tax return filed for the year of sale. It has been represented that Taxpayer initially intended to report the sale of stock on the installment method and never abandoned that intent between the date of the sale and the date of the submission this request for ruling. In the circumstances described, Taxpayer is granted permission to revoke the election out of the installment method for the sale of Y Corp stock to M and N.

This ruling is conditioned upon Taxpayer filing amended federal income tax returns for any taxable year impacted by this ruling. The ruling is further conditioned upon Taxpayer's determination and satisfaction of the liability, if any, for section 453A interest with respect to tax that is deferred through the use of the installment method to report Taxpayer's sale of Y Corp stock to M and N.

This ruling is subject to the following caveats:

1. No portion of the difference between the exercise price of the options granted M and N to purchase Y Corp stock and the value of such stock at the time was attributable to services or property which M or N provided to Taxpayer, TPB, or X Corp or which they agreed to provide to Taxpayer, TPB, or Y Corp in the future.

2. The exchange of Y Corp stock for X Corp stock complied with all applicable securities laws.

3. Taxpayer's sale(s) of Y Corp stock complied with all applicable securities

laws.

4. Taxpayer did not pledge the notes received from M and N or use the notes as security or collateral for any borrowing.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of any transaction described herein under any provisions of the Code and the Income Tax Regulations.

This ruling is directed only to the taxpayers who requested 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 in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,
CHRISTOPHER F. KANE
Chief, CC:ITA:3
Assistant Chief Counsel
(Income Tax and Accounting)

Enclosure: Copy of letter

cc: