Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

[Third Party Communication:
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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:4
PLR-122408-05

Date:
June 30, 2005

LEGEND:

Taxpayer =

Buyer =
State =
a =
b =
c =
d =
e =
f =
g =
h =
i =
o =
p =
k =
l =
m =
n =
date 1 =
date 2 =
s =
t =
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x =
y =

Dear :

This is in reply to your request for a ruling submitted by your authorized representative to allow Taxpayer to use an alternative method of basis recovery under § 15a.453-1(c)(7) of the Income Tax Regulations to report contingent payments, because the normal basis recovery rule method will substantially and inappropriately defer recovery of basis. In accordance with § 15a.453-1(c)(7)(ii), the ruling request was filed prior to the due date for Taxpayer's return including extensions. 1

Taxpayer is a State limited liability company that is treated as a partnership for federal income tax purposes. It uses an accrual method of accounting and files its returns on a calendar year basis. On date 1, Taxpayer was acquired by Buyer. Under the asset purchase agreement between Taxpayer and Buyer, the purchase price for Taxpayer's assets consisted of the following:

(1) a cash purchase price of $a (subject to adjustment),2

(2) Buyer's assumption of certain liabilities of Taxpayer at closing, and

(3) a deferred purchase price.

The deferred purchase price component of the purchase price consists of an earnout provision, under which the Buyer is obligated to pay theTaxpayer a defined percentage of earnings before income tax ("EBIT") in excess of $b in year u; $c in year v; $d in year w; and $e in year x. To the extent that any earnout payment is due, the Buyer will make such payment in the calendar year following the applicable earnout year. Thus, the Buyer must calculate its net sales for taxable years u through x, with any required earnout payments being made in taxable years v through y.

However, the Taxpayer does not expect to receive any earnout payments because its EBIT amounts for prior taxable years have been well below the baseline EBIT amounts necessary to trigger an earnout payment. The Taxpayer's highest EBIT amount was $f in year s, which was followed by substantial declines in years t and u.

Taxpayer has estimated the aggregate payments to be received during the term of the installment obligation, based on historical data and earning trends, and has computed a total sales price of $g, as summarized below:

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1 The Taxpayer's U.S. Federal Partnership Tax Return for year u has been extended until date 2.

2 The adjustment to the cash purchase price consists of: (i) holdback funds (held in escrow to secure the post-closing obligations of Taxpayer) and (ii) a purchase price adjustment (reflecting a dollar-for-dollar increase or decrease in the price based on certain balance sheet adjustments).

CASH PAYMENTS	TAXABLE YEAR RECEIVED	AMOUNTS	PERCENTAGE OF TOTAL SALES PRICE
At closing (including liability relief)	u	$h	p
Purchase Price Adjustment	v	$i	k
Earnout Payments	v – y	$0	l
Totals		$g	m

The Taxpayer states that under the normal basis recovery rule of § 15A.453-1(c)(3)(i), a pro rata basis recovery over the five-year installment period would result in only n of the Taxpayer's basis in the assets being recovered in year u. This would create a significant mismatch between the percentage of the total sale price received and basis recovery in year u. This would result in Taxpayer recognizing an overstated capital gain prematurely, and would also defer the ability to recognize a capital loss until y, the final year of the installment period.

To illustrate, the Taxpayer received p of the total sales price ($h/$g) in year u, and does not expect to receive any earnout payment in year v that would change that amount. If the Taxpayer is permitted to recover p of its basis in the disposed assets in year u this would produce a better match between cash received and basis recovered. Taxpayer would avoid a disproportionate amount of taxable gain in year u and significant capital loss in year y. Taxpayer represents that this alternative method of basis recovery is a reasonable method that will allow Taxpayer to recover basis more than twice as fast as the otherwise applicable normal, basis recovery method (p vs. n). Accordingly, the Taxpayer requests that under § 15A.453-1(c)(7)(ii) that it be permitted to allocate the same ratio of basis to each installment payment as that installment payment bears to the estimated amount of aggregate payments to be received by the Taxpayer during the five-year installment period, rather than equally over the five taxable years in which it might receive a payment from Buyer.

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

Section 453(c) defines the term "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 the payment is completed) bears to the total contract price.

Section 15a.453-1(c)(1) defines a "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 such sale or other disposition occurs. Unless a taxpayer makes an election under § 15a.453-1(d)(3), contingent payment sales are to be reported on the installment method.

Section 15a.453-1(c)(2)(i)(A) provides that a contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. Generally, the taxpayer's basis shall be allocated to payments received and to be received by treating the stated maximum selling price as the selling price for purposes of § 15a.453-1(b). If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule will apply.

Section 15a.453-1(c)(7)(i) provides that the normal basis recovery rules set forth in § 15a.453-1(c)(2) may, with respect to a particular contingent payment sale, substantially and inappropriately defer recovery of the taxpayer's basis.

Section 15a.453-1(c)(7)(ii) provides that the 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 rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) 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. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery.

Section 15a.453-1(c)(7)(ii) further provides that the taxpayer must file the request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. 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 based upon a specific event that has already occurred.

Section 15a.453-1(c)(7)(iv) provides that a contingent payment sale may initially and properly have been reported under the normally applicable basis recovery rule and, during the term of the agreement, circumstances may show that continued reporting on the original method will substantially and inappropriately defer or accelerate recovery of the unrecovered balance of the taxpayer's basis. In this event, the special rule provided in this paragraph is applicable.

Based on the information provided and the representations made, it is reasonable to conclude that the Taxpayer's use of the proposed alternative method of basis recovery will result in basis recovery at a rate 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, Taxpayer's use of the proposed alternative method of basis recovery is approved.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

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

Sincerely,

George Wright
Assistant Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)

cc: