

INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated November 4, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A	=
B	=
X	=
Date 1	=
Tax Years 1 & 2	=

ISSUE:

Whether interest on deferred tax liability under section 453A(b)(2) applies to the sale of producing gas properties in which a production payment is retained by the seller, A.

CONCLUSION:

Interest on deferred tax liability under section 453A(b)(2) applies to the sale of producing gas properties in which a production payment is retained by the seller, A.

FACTS:

A sold producing gas properties to B on Date 1, and A used the installment method to defer recognition of the gain. A did not treat the payments as contingent in computing the gain to be reported; the payments were valued and included in the total contract price. Nor did A elect an alternative method of basis recovery, which is required in contingent sales agreements. Thus, A viewed the payments as noncontingent for purposes of installment method reporting. A received X % of the properties' net cash flow through a retained production payment. The production payment is payable solely from a stated percentage of the reserves known to exist at the time the transaction was consummated.

A's position is that the interest on the deferred tax under section 453A(b)(1) does not apply to contingent obligations. Specifically, A argues that section 453A(b)(2) imputes an interest factor on deferred tax in the case of installment obligations that exceed a face amount of \$5,000,000 for any taxable year of a taxpayer. The production payment at issue does not provide a face amount or any stated principal sum due and owing, but rather provides for periodic payments measured by the volume of gas produced from the property burdened by the production payment and the sale price of that gas. Payments continue until a specified aggregate volume of gas has been produced. Thus, A argues, section 453A(c)(6) requires the Secretary of the Treasury to provide regulations necessary to carry out the provisions of that section in the case of contingent payments, and since regulations have not been proposed or issued, taxpayers are not required to devise a method by which the principal or face amount of a contingent obligation is to be determined.

A has also used the noncontingent bond method described in Prop. Reg. ' 1.1275-4(b) to determine the interest component of payments received under A's retained production payment from its sale of certain oil and gas properties to B on Date 1.

LAW:

Section 453A(a)(1), special rules for nondealers, provides that in the case of an installment obligation to which this section applies, interest shall be paid on the deferred tax liability with respect to such obligation in the manner provided under subsection (c).

Section 453A(b)(1), installment obligations to which this section applies, provides that this section shall apply to any obligation which arises from the disposition of any property under the installment method, but only if the sales price of such property exceeds

\$150,000.

Section 453A(b)(2), special rule for interest payments, provides that this section shall apply to an obligation described in paragraph (1) arising during a taxable year only if (A) such obligation is outstanding as of the close of such taxable year, and (B) the face amount of all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds \$5,000,000.

Section 453A(c)(1), interest on deferred tax liability, provides that if an obligation to which this section applies is outstanding as of the close of any taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined in the manner provided under paragraph (2).

Section 453A(c)(3) provides that the deferred tax liability is the product of the amount of gain with respect to the installment obligation that has not been recognized as of the close of the taxable years multiplied by the maximum rate of tax in effect under either section 1 or 11, as appropriate.

Treas. Reg. ' 15a.453-1(c)(1) provides that contingent payment sales are to be reported on the installment method.

Treas. Reg. ' 15a .453-1(c)(2)(i) 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. The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement.

Treas. Reg. ' 15a .453-1(d)(2)(iii) provides that any installment obligation which is not a fixed amount obligation is a contingent payment obligation and that the fair market value of a contingent payment obligation shall be determined by disregarding any restrictions on transfer imposed by agreement or under local law.

Treas. Reg. ' 1.446-1(a) provides that the term method of accounting includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated

consistently from year to year.

Treas. Reg. ' 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. See also Rev. Proc. 97-27, 1997-1 C.B. 680 (which provides the general procedures for obtaining the consent of the Commissioner to change a method of accounting for tax purposes).

Rev. Rul. 90-38, 1990-1 C.B. 57 explains that the treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of Treas. Reg. ' 1.446-1(e)(2)(ii)(a).

Rev. Proc. 97-27, section 2.01(1), explains that in determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the tax year in which the income is reported, it involves timing and is therefore a method of accounting.

Rev. Proc. 97-27, section 2.01(3), states that a change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another.

ANALYSIS:

A argues that the production payment is a contingent payment, and section 453A(b)(2) is not applicable because it imputes interest on installment obligations that exceed a face amount of \$5,000,000, and the production payment does not have a face amount, but rather provides for periodic payments measured by gas volume produced. Because regulations have not been proposed or issued stating how a face amount of a contingent obligation is to be determined, A's position is that the provision does not apply. We do not agree that section 453A(b)(2) cannot apply to this transaction.

A has adopted a noncontingent sale method of accounting for its installment sale

transaction, and apparently used it for tax years 1 and 2. We believe that as long as gain was properly computed, we should hold A to its chosen method of accounting. That is, for section 453 installment method purposes, A treated the transaction as noncontingent and thus, in this case a face amount can be determined for purposes of the deferred tax liability provisions of section 453A(b)(2). A's argument that the transaction is contingent but only for purposes of the deferred tax liability provisions of section 453A is disingenuous.

Although it appears to us that the payments are contingent, A treated the payments as noncontingent for purposes of installment method reporting. Under the installment method, any installment obligation that is not a fixed amount obligation is considered a contingent payment obligation. The value of the property transferred may be used as the basis for deriving the value of the contingent payment obligation. Treas. Reg. ' 15a.453-1(d)(2)(iii).

We understand from the revenue agent that A's computation of its gain was correct, and A obviously valued the property sold in order to compute gain. Thus, we believe that in the absence of a face amount, which does not exist with a contingent payment installment sale, it is

reasonable to look to the value assigned to the property and the gain recognized for purposes of applying the limitations of section 453A(b)(1)&(2).

In the absence of regulations under section 453A(b) defining face amount for contingent payment obligations, we conclude that it is reasonable to look to a taxpayer's calculation of the value of the transferred property (used in calculating its gain on the transaction) in order to ascertain a face amount of the installment obligation for purposes of section 453A(b)(2). The deferred tax liability is then calculated using the appropriate tax rate and the unrecognized gain as of year end. ' 453A(c)(3).

Alternatively, because the production payments are based on the net cash flow from a specified volume of gas from proven reserves, it appears that a stated maximum selling price could be determined. As provided in Treas. Reg. ' 15a .453-1(c)(2)(i), we assume that all contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price. On these facts, this would seem to also be a viable approach for establishing the face amount of the obligation, given the strong likelihood that the production payments will be paid in full.

We have reviewed relevant legislative history and did not find anything helpful for this issue. The Conference Report to accompany H.R. 3545, "Omnibus Budget Reconciliation Act of 1987" states at page 930 that the conferees anticipate that the

regulations relating to contingent payments will address the treatment of contingent payments for purposes of the \$5 million threshold and for purposes of determining the amount of gain that remains to be recognized under an installment obligation as of the end of any taxable year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



We note, though, that if you determine that, under these facts, gain was computed incorrectly, you could require A to treat the transaction as a contingent sale under the installment method. The failure of the Commissioner to object to a method of accounting or to the continued use of a method for a number of years does not constitute approval of the method or prevent the Commissioner from changing the method on audit. Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324 (1971), acq. 1973-2 C.B. 1, aff'd per curiam, 496 F.2d 876 (1974); Holt v. United States, 368 F.2d 311 (5th Cir. 1966).

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