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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTH-SOUTH CAROLINA
DISTRICT, GREENSBORO
CC: SET:NCS:GBO
Attn: Steven M. Webster, Senior Attorney

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Sale of Stock under Installment Method

This Field Service Advice responds to your memorandum, dated July 14, 1999. 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::

Mr. X =
Mr. Y =
Mr. Z =
Corp A =
Corp B =
Corp C =
Corp D =
b =
c% =
$d =
$e =
$f =
g =

$h =
i% =
$j =
$k =
$m =
$n =
$o =
$p =
$q =
$r =
$s =
$t =
$u =
v% =
w% =
$x =
$y =
$z =
$aa =
bb =
Calendar Year 1 =
Calendar Year 8 =
Calendar Year 9 =
Calendar Year 10 =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Tax Year 4 =
Tax Year 5 =
Tax Year 6 =
Tax Year 7 =
Tax Year 8 =
Tax Year 9 =
Tax Year 10 =
Tax Year 11 =

ISSUE::

The correct treatment in Tax Year 12 of final payments made to settle an earlier buyout agreement of stock owned by the taxpayer, Mr. X.

CONCLUSION::

The buyout agreement executed in Tax Year 1 should be treated as a contingent installment sale. Basis should have been recovered ratably in accordance with Temp. Treas. Reg. § 15.453-1(c)(3). The payments made in Tax Year 12 should be treated as disposition of an installment obligation under section 453B(a)(1). In addition, the charitable contribution of an interest in the buyout agreement would produce a disposition under section 453B(a)(2).

FACTS:

Background

In Calendar Year 1, Mr. Y and Mr. Z formed Corp A to own and operate serving the general public. Corp B was formed as the operating company

One of the first business entities was owned by Mr. X. Mr. X expressed an interest in the business and became involved while Mr. Y handled the business entities and other operations.

From Corp B's inception, Corp C owned most of Corp B’s stock and Corp A owned the rest. Corp C later became Corp D. Mr. X acquired stock in Corp D while he was employed by Corp B and eventually accumulated b shares. Mr. X worked for Corp B until about Calendar Years 9 or 10. Apparently, Mr. X became dissatisfied with the way the business was being run and left the company.

There is evidence that Mr. X was instrumental in the developmental stages of Corp B,

In addition, there is evidence that Mr. X was involved in fending off a hostile takeover in Calendar Year 8. Mr. X may have acquired many of his shares in Corp D during the takeover attempt.

Agreement in Tax Year 1

Early in Tax Year 1, Corp D was merged into Corp A, which became the sole stockholder of Corp B. Under the merger agreement, each share of Corp D Common Stock would be exchanged for one share of Corp A Special Common Stock. Prior to the merger, Mr. X owned c% of the Corp D Common Stock. Although Corp D Common Stock was not appraised at the time of the merger, records show that it was purchased by the public the year before for a low of $d and a high of $e per share. Other known transactions in that year, including shares purchased and sold by officers and directors of the corporation, show the stock reached a high of $f per share.

Mr. X was dissatisfied with the merger. Accordingly, he exercised dissenter's rights to the merger and elected to receive the "value" of his shares of Corp D Common stock. Negotiations ensued and Mr. X and Corp A entered into the settlement agreement which provided the following would be paid to Mr. X:

> 1. A g-year $h unsecured promissory note paying interest only at i% per annum;
>
> 2. Amounts labeled as "Bonus Compensation" in the agreement to be made for the period during which the note was outstanding and equal to a one-time payment of $j, plus an annual payment, which apparently was equal to c% of Corp B's annual net after tax earnings in excess of $k. , to be made for the period during which the note was outstanding.

The Bonus Compensation provision stated that it was additional compensation for past and future services to Corp B and in recognition of Mr. X's contribution to the past success of Corp B and for the valuable consideration reflected in the agreements of Section 4 .

Section 4 is titled "Goodwill and Support of [Mr. X]" and reads as follows:

> [Mr. X] agrees that for so long as the Note is outstanding, he will support the management of [Corp B] and not take any action that may damage the business reputation of [Corp B] or interfere with the ongoing business of [Corp B] in any way. [Mr. X] acknowledges and agrees (i) that his agreement in this regard is an important consideration to [Corp A] with respect to [Corp A's] obligations under Section 2 hereof; (ii) that [Corp A] would not have included in this Agreement the terms contained in Section 2 hereof if this agreement was not explicitly a provision hereof . . .

There is no evidence that Mr. X performed any services to Corp B or Corp A after leaving the Corp B prior to the merger, other than to offer his unsolicited advice occasionally. There was no requirement under the agreement that Mr. X perform services in the future.

Corp A paid Mr. X interest on the note in Tax Years 1 though 11. In addition, it paid the following amounts under the Bonus Compensation provision.

Tax Year 1 - $m
Tax Year 2 - $n
Tax Year 3 - $o
Tax Year 4 - $p
Tax Year 5 - $q
Tax Year 6 - $r

In Tax Years 7 though 11, no amounts were paid under the Bonus Compensation provision. There is evidence that Mr. X did not report any of the payments attributable to the Tax Year 1 agreement on his returns for Tax Years 1 through 11.

Agreement in Tax Year 12

Under the terms of the note, which were incorporated into the Tax Year 1 agreement, either party could "call" the agreement after bb years with a "prepayment premium" based on a formula incorporating the Bonus Compensation provision. Late in Tax Year 11, Corp A decided to call the note in accordance with its terms. Negotiations ensued but Mr. X appeared unwilling to have the note called under any circumstances. There is evidence that Mr. X believed he had an informal promise from Mr. Y that the note would remain outstanding until maturity and that he considered himself to still be a stockholder in Corp B with a c% ownership interest. His counteroffers for accepting the call were based on his receiving c% of the total value of Corp B, which was estimated to be from $s to $t.

Mr. X also contended that Corp A was in breach of the Tax Year 1 agreement. He asserted that Corp B had begun to pay Corp A unreasonable management fees subsequent to the Tax Year 1 agreement which directly affected his Bonus Compensation payments. Mr. X apparently argued that the management fees were an unreasonable intercompany expense that should have been reversed before calculating the yearly Bonus Compensation payments. If Mr. X was correct, he was due roughly $u in additional payments under the Bonus Compensation provision for the Tax Years prior to Tax Year 11.

Corp A contended that the management fees paid by Corp B to Corp A were reasonable payments for the leadership, guidance, and management services provided by a parent to its subsidiary during a difficult period in the corporate history. In recent years, Corp B was under intense competition pressures.

In Tax Year 12, Mr. X created what has been characterized as a charitable remainder unitrust (Trust A) and a charitable trust (Trust B). Mr. X transferred into the trusts his interest in the Tax Year 1 agreement, excluding his rights in the promissory note, and his rights to the Bonus Compensation payments. Trust A received a v% undivided interest in the described property, and a charitable trust received a w% undivided interest. It is not clear what rights to payments Mr. X had under Tax Year 1 agreement, other than those excluded from the contribution.

An agreement regarding settlement of claims was reached later in Tax Year 12. Those representing Corp A and B decided it was in the best interest of those corporations to pay $x to end the matter. Their decision, in large part, was influenced by Corp A learning that Mr. X intended to donate, through the two trusts, a substantial portion of the settlement to a local educational institution. The Tax Year 12 settlement agreed upon the following amounts:

$h	Paid pursuant to the promissory note
$y	Paid pursuant to the prepayment premium based on the Bonus Compensation provision
$z	Paid under the "remaining provisions" of the Tax Year 1 agreement to fund the two trusts
$x	

With respect to the "remaining provisions" aspect of the Tax Year 12 agreement, the document provides that the amounts -

> shall be paid . . . in complete satisfaction of the disputes relating to [Corp A’s] obligations under the remaining provisions of the [Tax Year 1] agreement excluding [Corp A's] obligations under the Note and Paragraph (2)(a) of the [Tax Year 1] [a]greement.

Mr. X reported $h and $y as capital gain items on his Tax Year 12 federal income tax return. He also claimed a basis of $aa, which was apparently his basis in his stock.

<u>LAW AND ANALYSIS:</u>

Installment sale

As a general rule under section 453(a), income from an installment sale is taken into account under the installment method.

Section 453(b)(1) defines “installment sale” to mean a disposition of property where at least 1 payment is to received after the close of the taxable year in which the disposition occurs. For the purpose of section 453(b)(1), payments do not include evidences of indebtedness of the purchaser that are not payable on demand, readily tradeable or unsecured. <u>See</u> I.R.C. § 453(f)(3); Temp. Treas. Reg.

§ 15A.453-1(b)(3)(i).

The Tax Year 1 agreement is an installment sale because at least one payment attributable to the sale of the stock (at the very least, the payment on the note) was to be received after Tax Year 1, the year of the sale.[1] The term installment sale includes dispositions from which payment is to be received in a lump sum in a taxable year after the year of sale. Temp. Treas. Reg. § 15A.453-1(b)(1)

Section 453(c) defines "installment method" to mean 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 price.

Contingent Payment Sale

A contingent payment sale is 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 that sale or other disposition occurs. Treas. Reg. § 15A.453-1(c)(1). The sale occurring in Year 1 in the present case would be a contingent payment sale because of the payments contingent on the net income of Corp B. Prior to the Enactment of the Installment Sale Revision Act in 1980 (P.L. 96-471), a sale for a contingent price did not qualify as an installment sale. S. Rept. No. 1000, 96th Cong., 2d Sess. 22 (1980), citing Gralap v. United States, 458 F.2d 1158 (10th Cir. 1972); In re Steen, 509 F.2d 1398 (9th Cir. 1975). The Act enacted I.R.C. § 453(j), which required the Secretary to prescribe regulations which provide for the ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

Because of the contingent payments, no maximum selling price for the stock could be determined by the end of Tax Year 1. However, the maximum period over which payments would be received was known, that is, the period of the note or b years. Under the regulations, when a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's 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. Temp. Treas. Reg. § 15A.453-1(c)(3)(i). Therefore, Mr. X should have been recovering 1/g of his basis

[1] The prohibition currently found in section 453(k)(2)(A), which denies the use of the installment method to certain stocks and securities is not applicable to sales occurring in the tax year in question.

in the stock each year. That part of the installment obligation, that is, the part represented by the note, is fixed and part of the obligation is contingent does not change this result. See Temp. Treas. Reg. § 15A.453-1(c)(3), Ex. (4).

However, in several taxable years, Mr. X received no payments, except interest, although Bonus Compensation payments were provided for each year. Temp. Treas. Reg. § 15A.453-1(c)(3)(i) provides that, if no payment is received or the amount of the payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed except in circumstances not relevant here. When no loss is allowed, the unrecovered portion of the basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. Id. Thus, under the facts presented, the part of the basis that otherwise would have been allocable to Tax Years 7 through 11 will be carried over to Tax Year 12.

Election Out of the Installment Method

Under section 453(d)(1), section 453(a) does not apply to any disposition if the taxpayer elects to have it not apply. Under the regulations, unless the taxpayer elects not to report the sale on the installment method, a contingent payment sale must be reported on the installment method. See Treas. Reg. § 15A.453-1(c)(1).

Section 453(d)(2) states that, except as otherwise provided by regulations, an election under section 453(d)(1) may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return for the taxable year in which the disposition occurs. Temp. Treas. Reg. § 15.453-1(d)(3)(i) requires that the election be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election out of the installment method. Id.

There is no evidence the that Mr. X made a qualifying election out of the installment sale method.

Disposition of an installment obligation

Under section 453B(a), if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the fair market value of the obligation at the time of distribution, transmission or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

Section 453B(b) defines the basis of an installment obligation as the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

It is clear under the regulations that a installment obligation can contain both a fixed amount component and a contingent component as does the installment obligation in the present case. See Treas. Reg. § 15A.453-1(d)(2)(iii). In short, the Tax Year 1 agreement is an installment obligation.

Mr. X gave an interest in the Tax Year 1 agreement to Trusts A and B. The contribution of a installment obligation to charity is considered a disposition. Rev. Rul. 79-371, 1979-2 C.B. 294. As a result, Mr. X would have a gain calculated under section 453B(a)(2) and section 453B(b) when the contribution was made. Mr. X would also have a gain calculated under sections 453B(a)(1) and 453B(b) when the installment obligation is subsequently paid off under the Tax Year 12 agreement at an amount other than face value of the note. Under the flush language of section 453(a), the character of the gain will be determined by the nature of the property sold in Tax Year 1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Characterization of the contingent payments

The characterization of the payments contingent upon net income of Corp B could have an impact on how the sale should be treated. You would like to argue that the amounts are ordinary income. However, as discussed below, this characterization potentially cuts both ways, because the installment method may not be available if the payments are for past services. In addition, we think it will difficult, if not inappropriate, to characterize the amounts as ordinary income whether as compensation or otherwise.

Certainly, in certain circumstances, taxpayers can be held to allocations under a contract and, in the present case, the Tax Year 1 agreement characterized the contingent payments as compensation. The amount of proof required for a taxpayer to challenge its characterization of an allocation depends upon the circuit and the court. It is Service position that taxpayers must meet the rule of Commissioner v. Danielson, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967). However, only certain courts have adopted Danielson. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United

States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir.), cert. denied, 469 U.S. 882 (1984); Spector v. Commissioner, 641 F.2d 376 (5th Cir.), cert. denied, 454 U.S. 868 (1981). Under Danielson, a taxpayer is bound for tax purposes by contracts, to which it agreed, absent evidence adducing proof which would be sufficient to alter the terms or to show the contract unenforceable because of mistake, undue influence, fraud, or duress.

Courts that have rejected Danielson still generally follow Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), and require that taxpayers adduce "strong proof" in taking a tax position at variance with their contracts. See Meredith Corp. v. Commissioner, 102 T.C. 406, 438 (1994) and the cases cited therein. For example, the Tax Court has adopted the "strong proof" rule and has refused apply Danielson outside of circuits that recognize it. See, e.g., Anderson v. Commissioner, 92 T.C. 138, 171 (1988).

The present case, which arises in the Fourth Circuit, is potentially governed by a another standard, the “economic reality test.” See General Insurance Agency, Inc. v. Commissioner, 401 F.2d 324 (4th Cir. 1968). The two prongs of the "strong proof" rule developed in the Ninth Circuit are the same two prongs of the "economic reality" test found in General Insurance, 401 F.2d at 330, which cites the same Ninth Circuit cases as their source. See Proulx v. United States, 594 F.2d 832, 838 (Ct. Cl. 1979), which discusses this development. Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), agreed with the language in Ullman regarding the necessity of strong proof, but added that the covenant that was the subject of the suit "must have some independent basis in fact or arguable relationship with business reality." Annabelle Candy Co., Inc. v. Commissioner, 314 F.2d 1, 7 (9th Cir. 1962), added the requirement of an intent to make an allocation to the item in question at the time of the agreement. The "strong proof" rule is now stated to require that the taxpayer show strong proof that the asserted allocation is "correct based on the intent of the parties and economic realities." Meredith Corp. v. Commissioner, 102 T.C. at 438, citing Major v. Commissioner, 76 T.C. 239, 247 (1981).

Thus, it has been held that the "economic reality" test and "strong proof" rule are the same standard. Montelepre Systems, Inc. v. Commissioner, T.C. Memo. 1991-46, aff'd, 956 F.2d 496 (5th Cir. 1992), citing Rich Hill Insurance Agency, Inc. v. Commissioner, 58 T.C. 610, 616 (1972). The "strong proof" rule requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1434, n.15 (1986), acq. in result in part, 1990-2 C.B. 1. Not only is the “strong proof” rule a different standard of proof, it also by its terms allows the taxpayer more leeway than the Danielson rule in showing the proper characterization of the course of action followed by showing the intent of the parties at the time.

There is also some authority that the "economic reality" test of the Fourth Circuit is a rule unto itself. See Furman v. United States, 602 F. Supp.444, 456 (D.S.C. 1984), aff'd without opinion, 767 F.2d 911 (4th Cir. 1985); Lambert v. United States, 409 F.Supp. 1015, 1018 (W.D. Va. 1976). We think that this may mean that the Fourth Circuit applies the same two prongs as the "strong proof" rule but does not require the higher standard of proof. Our conclusion is supported by Major, 76 T.C. at 249, which came to this conclusion regarding the "economic reality" test of the Seventh Circuit. Major, 76 T.C. at 247 n.6, also listed the Fourth Circuit, along with the Seventh, as one that had not adopted the "strong proof" rule, citing General Insurance. [2] Ignoring the question of intent, the important question here is whether characterizing part of the amounts as ordinary income items has "independent basis in fact or arguable relationship with business reality." General Insurance, 401 F.2d at 330, quoting Schulz, 294 F.2d at 55.

In regard to the characterization of the amounts as compensation, there is little evidence that Mr. X performed services for Corp B after Tax Year 1 agreement was entered. It is more convincing that the amounts are for past services. Such payments are not precluded from being characterized as compensation. Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930); Custom Chrome, Inc. v. Commissioner, T.C. Memo. 1998-317. It must be shown that there was not sufficient compensation in the prior tax years and that the amounts at issue were meant to be for that underpayment. Estate of Wallace v, Commissioner, 95 T.C. 525, 553-54 (1990), aff'd on another issue, 965 F.2d 1038 (11th Cir. 1992); Avis Industrial Corp. v. Commissioner, T.C. Memo. 1995-434.

Although there may be facts supporting such conclusions in the present case, there is a additional problem in that the payments are contingent on net income. Such payments may be deemed dividends, rather than compensation, when they are paid to shareholders of the corporation, even if the amounts are reasonable. See Klamath Medical Service Bureau v. Commissioner, 29 T.C. 339 (1957), aff'd, 261 F.2d 842 (9th Cir. 1958), cert. denied, 359 U.S. 966 (1959). That the payments were not made to a current shareholder but as part of a sale of stock should not change the perception that they are payments related to the ownership of stock rather than compensation. Thus, the regulations governing the deduction of

[2] This conclusion is also supported by an the unpublished opinion provided in VanLandingham v. Commissioner, T.C. Memo. 1987-66, aff'd per curiam in an unpublished opinion, 836 F.2d 1343 (4th Cir.), cert. denied, 487 U.S. 1237 (1988). There, the Fourth Circuit affirmed on the basis of General Insurance, yet stated it did not necessarily endorse the strong proof rule. (The Fourth Circuit does not approve of general reliance on unpublished opinions.) See also Maryland National Bank v. Commissioner, T.C. Memo. 1974-209, aff'd per curiam, 75-1 USTC ¶ 9385 (4th Cir. 1975).

compensation recognize that an ostensible salary may be a payment for property. Treas. Reg. § 1.162-7(b)(1).

Treas. Reg. § 1.162-7(b)(2) states that compensation based upon any form of contingentcy invites scrutiny and provides the following standards for deduction:

> Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on a fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

The present case fails the standard set forth in the regulations in two ways - the contingent payments are for past services and there is other consideration, i.e., the transfer of stock, involved. Although the proposed position in the present case may not conflict with the regulations, at the very least it, potentially compromises the Service's position on the deduction of contingent compensation.

Further, rights for compensation for past services cannot be reported under the installment method. See Sorenson v. Commissioner, 22 T.C. 321, 342 (1954). Compare Realty Loan Corp. v. Commissioner, 54 T.C. 1083,1098 (1970), aff'd, 478 F.2d 1049 (9th Cir. 1973). Thus, it could be argued that all or part of the sale is disqualified from being reported under the installment method and, as a result, all or part of gain currently attributable to Tax Year 12 should have been reported in Tax Year 1, which is a closed year.

We think it could be successfully argued that the sale of stock should still be an installment sale and that the sale of rights for compensation should be treated separately. There is authority that similar agreements sold be treated separately from the sale of a business. See Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966); Roberts v. Commissioner, T.C. Memo. 1983-143.

Further, rights to payments for future services are property and can be reported on the installment method. Foy v. Commissioner, 84 T.C. 50, 74-75 (1985); Realty Loan, 54 T.C. at 1098. Thus, it could be argued that the Tax Year 1 agreement contemplated both past and future compensation and no allocation between the two was made. Still we do not think the Service should risk shifting the payments to a closed year under these facts.[3]

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[3] If the contingent payments are bifurcated from the sale of the stock, the sale would no longer be a contingent payment sale. Even without the contingent payments,

However, that the amounts may not be attributable to past services would not preclude their characterization as payments for a covenant not to compete, which would be ordinary income to Mr. X. See General Insurance, 401 F.2d at 329. In addition, a covenant not to compete would involve future rather than past performance. The Tax Year 1 agreement indicates that the agreement does not restrict the taxpayer from competing with Corp A. However, that the agreement indicates that Bonus Compensation would not have been provided absent the taxpayer's agreement to support the management of Corp B could be interpreted as a covenant not to compete.

In addition, the amounts at issue in Tax Year 12 were characterized as a “prepayment premium” in Tax Year 12 agreement. The premium was based on a formula incorporating the Bonus Compensation provision, and thus arguably was not itself compensation. A prepayment premium is in essence interest and therefore ordinary income. See American Life Insurance v. Commissioner, 25 T.C. 1265 (1956), acq. 1956-2 C.B. 5; Rev. Rul. 73-137, 1973-1 C.B. 68. In addition, taxpayers have been held to their characterization of amounts as interest. See Bradley, supra; Taiyo Hawaii, supra; Russo v. Commissioner, 68 T.C. 135, 143-44 (1977). But it would be hard to argue all of the amount paid as a prepayment premium has economic reality as interest under these facts, because the prepayment premium exceeded the face amount of the note.

From the facts currently presented, we think the appropriate characterization of the entire Tax Year 1 agreement is a sale of the stock. The contingent payments were based on the percentage of Mr. X’s stock ownership. This indicates that the amounts were not compensation but payments in regard to stock ownership. See, e.g., Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987); Huckins Tool and Die, Inc. v. Commissioner, 289 F.2d 549 (7th Cir. 1961); Northlich Stolley, Inc. v. United States, 368 F.2d 272 (Ct. Cl. 1966). In addition, the contingent payments were to last only as long as the note which was clearly for the payment for the stock. The length of note, which could be and was shortened by prepayment, has no relevance to the amount of compensation due to Mr. X. Further, if Mr. X were to be compensated for past services, it logically would have happened when he left the company’s services, not when he sold his stock. On the other hand, the note for a fixed amount appears to equal or exceed the fair market value of the stock in Year 1. This indicates that the contingent payments

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the sale of stock would still be an installment sale because the note was not payable until a tax year after the year of sale. However, basis would not be ratably recovered, but would all be recovered in Tax Year 12, using the gross profit percentage, when the one and only payment of attributable to sale was made.

are for something other than for the payment of the stock. See Yelencsics v. Commissioner, 74 T.C. 1513, 1525 (1980), acq. 1981-2 C.B. 2; Rev. Rul 58-614, 1958-2 C.B. 90.

Still, the reality of the situation seems to be that Mr. X no longer wanted to be involved with Corp A and Corp B by Tax Year 1 but foresaw potential growth in the companies in which he thought he deserved to participate. As such, in consideration for his substantial stock ownership, he received a guarantee of participation in the profits of Corp B for at least bb years and potentially g years. Corp A may have been willing to pay the additional amounts to settle the dissent to the merger and avoid litigation.

Open transaction doctrine

Your submission raises the potential application of the open transaction doctrine to the present case. The open transaction doctrine or cost recovery method was approved in Burnet v. Logan, 283 U.S. 404 (1931). Under the method, no gain is realized until basis is recovered. If the sale remains open, the deferred payments are applied in reduction of basis as received, and only when the amount received exceeds basis is there a taxable gain.

A cost recovery method is not an installment sale method; therefore, for the sale to be treated as an open transaction, Mr. X would had to have properly elected out of the installment sale method. See Temp. Treas. Reg. § 15A.453-1(d)(1) and § 15A.453-1(d)(2)(iii). Again, there is no evidence that Mr. X made such an election.

Further, the open transaction doctrine should have very limited applicability after the Act. The use of the method should be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot be reasonably ascertained. Temp. Treas. Reg. § 15A.453-1(d)(2)(iii); S. Rept. 96-1000 at 24. In addition, the Ninth Circuit has held that the cost recovery method is only available when the taxpayer does not know whether or not it will realize a gain. See Tribune Publishing Co. v. United States, 836 F.2d 1176, 1180 (9th Cir. 1988).

In any case, we do not agree that the open transaction doctrine will accomplish what you have argued it will, that is, the characterization of the payments made under the Tax Year 12 agreement. Instead, the flush language of section 453B(b) would control and, under it, the gain recognized from the disposition of the installment obligation is regarded as being derived from the property sold.

Installment note as equity rather than debt

The taxpayer has argued that he retained an equity interest in the corporation. Under Temp. Treas. Reg. § 15A.453-1(c)(1), the term "contingent payment sale" does not include transaction with respect to which the installment obligation represents under applicable principles of tax law, an equity interest in a corporation or similar transaction, regardless of the existence of a stated maximum selling price or a fixed payment term.

In determining whether an installment obligation is equity, the temporary regulations look to proposed regulations under section 385 which were withdrawn in 1983 and had an effective date after the sale in question. See Temp. Treas. Reg. § 15A.453-1(c)(8)(i). However, case law governing debt/equity issues would determine whether the installment note was in fact equity in this case. See Id. That payments on the installment obligation were based on the income of the company is an indication that the interest might be equity, but it is clearly not sufficient. See Temp. Treas. Reg. § 15A.453-1(c)(3)(ii), Ex. (3) and Ex. (4).

In addition, the Tax Year 1 agreement characterized the installment obligation as debt. A taxpayer can be bound by his characterization of an amount as debt rather than equity. See, e.g., Bradley, supra; Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997); City of New York v. Commissioner, 103 T.C. 481 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995); Litchfield v. Commissioner, T.C. Memo. 1994-585, aff'd in an unpublished order, 97-2 USTC ¶50,536 (10th Cir. 1997) ; Miller v. Commissioner, T.C. Memo. 1989-153, aff'd in an unpublished opinion, (6th Cir. 1990). However, as previously discussed, the precedent of the Fourth Circuit may not be as strong as that employed in some of the cases cited, which are from other circuits. See General Insurance, supra. But see Taiyo Hawaii, which holds the taxpayer to its characterization of debt without employing any particular standard. In addition, the assertion that the installment obligation is in fact debt has economic reality.

If the installment note is determined to be an equity interest, there would be no installment sale of stock in Tax Year 1, but only the sale of the equity interest in Tax Year 12. The Tax Year 12 agreement would not be treated as a disposition of an installment note. The contingent payments and interest payments would arguably be dividends. The charitable contributions would arguably be contributions of an equity interest.

Alternative Basis Recovery

It could be argued that basis should not be recovered ratably because of the disproportionately large payment on the note that was expected at the end of the transaction. Under Temp. Treas. Reg. § 15A.453-1(c)(7)(ii), a taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate in a timely manner that the application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. However here, it is the taxpayer that wants to defer basis recovery. Further, under the temporary regulations cited, the taxpayer must request and receive timely permission to use an alternative method of basis recovery.

Charitable contribution

In Tax Year 12, Mr. X made a charitable contribution of all his interests in the Tax Year 1 agreement other than the payments under the note and the compensation payments. There no other apparent rights or at least valuable rights in the agreement. It appears taxpayer's position is that only the payments excepted from the contribution are part of the installment obligation. However, this seeming attempt to avoid section 453B will not work since the entire agreement is an installment obligation. Seeing the whole agreement as a sale of stock solidifies this approach.

In addition, there does not have to be a direct contribution of the installment obligation or contribution of a whole obligation for the disposition to occur. Thus, a partner who contributes his partnership interest to a charity realizes ordinary income to the extent of his share of unrealized profits on the installment obligations of the partnership. Rev. Rul. 60-352, 1960-2 C.B. 208.

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