ALTERNATIVE BASIS RECOVERY METHODS FOR CONTINGENT PAYMENT SALES

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Tags
Adjusted Basis
Installment Sale

INTRODUCTION

Basis recovery is important when a taxpayer sells property and recognizes gain over a period of time or when a taxpayer acquires property other than inventory that is used in a trade or business and wishes to depreciate or amortize the cost of the property over its useful life.

The U.S. applies special gain recognition rules when property is sold and at least one payment is received by the seller after the close of the selling year. When this occurs, gain is recognized under the installment method of accounting unless the taxpayer elects otherwise. This means that gain is recognized as payments are received. In addition to deferred recognition of gain, the installment method requires that basis generally be recovered at the same time gain is recognized. In that way, generally, neither will be "front loaded" by allocation to early payments.

To determine the portion of each payment that is allocated to gain, each payment is multiplied by the gross profit percentage ("G.P.P."). The G.P.P. is calculated in three steps:

1. The total consideration in the transaction is identified. Typically, this equates to the total sales price.
2. The consideration is reduced by the adjusted basis at the time of sale. This results in the gain.
3. The gain is divided by the total selling price.

Once the gain element in each payment is determined, the balance of the payment is recovery of basis.

When the price is contingent, meaning the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs, special methods apply for allocating the basis to payments called for in the sales transaction. Typically, the basis is allocated in equal amounts to all years in the payment schedule. Any amount received in a year that exceeds the basis allocated to the year is gain.

When the contract has neither a determinable maximum selling price nor a method to determine the time over which payments will be received, the contract will generally be closely scrutinized by the I.R.S. If sale treatment is still allowed, basis will be recovered in equal increments over a period of 15 years.[1]

In typical situations, basis recovery for property used in a trade or business is done by depreciating the total cost of the property over its useful life (as determined for

[1] Teas. Reg. §15a.453-1(c)(4).

tax purposes). However, when the asset used in a trade or business is a copyright or another item of intangible property, the typical basis recovery rules may distort net income because income is significantly front loaded while basis recovery is deferred.

NORMAL METHODS OF RECOVERY WHERE NO DISTORTION OF BASIS RECOVERY IS EXPECTED

Installment Sale – Maximum Selling Price Known

When the maximum selling price is stated or determinable based on the contract, the taxpayer generally allocates the basis in the property to each payment under the regular installment method as if the selling price was fixed, treating the maximum contract price as the selling price.

Installment Sale – Maximum Selling Price Unknown/Fixed Payment Period Known

When the maximum selling price cannot be determined before the end of the tax year in which the sale occurs, but the period over which payments will be made is known and is fixed, the taxpayer must generally allocate the basis over the fixed number of years determined in the contract in equal annual increments. This rule applies, for example, when the selling price is expressed as a fixed percentage of gross income over a fixed period of years, or when the selling price is fixed but denominated in a currency that is not the U.S. dollar.

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However, if the selling price incorporates a component that is not identical for all taxable years (*e.g.*, an increasing or decreasing percentage of gross income to be payable over the term of the contract), the basis recovery must take into account that component unless it is inappropriate to presume that the payments are likely to accord with the variable component.

No loss is allowed until the last year in the fixed payment period. When no loss is allowed, the unrecovered basis is carried forward to the next year.

Depreciation of Operating Assets – Income Forecast

The income forecast method is applicable to the recovery of basis in the form of depreciation or amortization deductions rather than as an installment sale. Under Code §167(g)(6), use of the income forecast method is limited to motion picture films and videotapes, sound recordings, copyrights, books, patents, and other property as specified by I.R.S. regulations. For these items of property, the revenue stream is front loaded. Because the revenue stream is not related to the useful life, application of typical depreciation or amortization rules is expected to result in a distortion of the taxpayer's income over time. In this case, the taxpayer may elect to use the income forecast method.[2] An election to use the income forecast method is made on a timely-filed return for the first year under the contingent payment agreement in which a payment is received.

Under the income forecast method, the taxpayer may estimate the total payments that are expected to be received over a ten-year period. In each year, the taxpayer

2 Code §167(g).

may recover a greater or lesser portion of total basis in a manner that is synchronized with fluctuations in the receipt of income. The steps that are used to compute basis recovery in any year are as follows:

1. Determine the payment received in the tax year (excluding interest).

2. Determine the total payments (excluding interest) that are forecasted to be received under the contract.

3. Divide the payment for the year by the total forecasted income that will be generated by the asset.

4. Multiply the percentage determined in the third step by the original basis.

Note that the estimate of total payments may be changed at a later date if it is found to be substantially overestimated or underestimated due to circumstances occurring in that later year. Under a lookback rule, changes in the forecast of income will affect previously-claimed depreciation deductions. This affects the computation of tax for prior years. Interest will be due on underpayments of tax in prior years. Taxpayers are entitled to interest in the event depreciation was understated. No loss is recognized until the final payment year.

THE ALTERNATIVE METHOD TO AVOID SUBSTANTIAL DISTORTION

Although the income forecast method is limited to certain specified items of intangible property, a comparable method is permitted for other assets, provided I.R.S. approval is obtained. If a taxpayer can show that the use of the regular methods described above would substantially and inappropriately defer the taxpayer's basis recovery, the taxpayer may request the I.R.S. allow the use of an alternative method which will allow for a quicker recovery of basis.[3]

The taxpayer must receive a ruling from the I.R.S. before using the alternative method. The submission of the request for a ruling must generally be made before the due date for filing the return for the year in which the first installment payment is received (including extensions).

The request for the ruling to use the alternate method must be in accordance with all applicable procedural rules and any applicable revenue procedures relating to submission of ruling requests.[4]

The taxpayer must demonstrate that the normal methods will substantially and inappropriately defer the basis recovery. To demonstrate this, the taxpayer must show that

- the proposed method is a reasonable method; and
- under that proposed method, it is reasonable to conclude that recovery of basis will be at least twice as fast as under the regular methods.

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[3] Treas. Reg. §15A.453-1(c)(7)(ii).

[4] Rev. Proc. 2012-9, 2012-2 IRB 261.

A taxpayer's demonstration should be based on "contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification." The I.R.S. generally only accepts projections if based upon a specific event that has occurred already.

An alternative method usually applies for all years in which payments are received. However, if facts change over the life of a contingent payment obligation, an alternative method may be instituted for a later year. Similarly, in cases where one of the normal methods was initially applied but during the term of the contract circumstances show that a continued use of the applied method will substantially and inappropriately defer the recovery of the basis, the taxpayer may apply for a ruling to allow a use of the alternative method.

An alternative method may also be applied without the taxpayer's request. If the I.R.S. finds that the normal basis recovery methods will substantially and inappropriately accelerate the basis recovery, it has the authority to require the use of an alternative method. In such cases, the alternate method must be used unless the taxpayer can demonstrate that

- the alternate method is unreasonable for ratable recovery; or
- under that method, it is reasonable to conclude that basis recovery will not be at least twice as fast as under the normally applicable methods.

A taxpayer's defense against an I.R.S. alternative method may be based on "contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification," and in special cases where the I.R.S.'s consent was given, on a reasonable projection based on one or more events that have already occurred.

Example

T sells the stock of the X Corporation for $1.8 million in cash and the buyer's agree to pay T an amount equal to 1% of X's net profits in each of the next ten years. T's basis in the stock is $100,000 and the contract provides for adequate stated interest.[5] The maximum amount that may be paid to T (exclusive of interest) may not exceed $10 million.

Because the contract has a maximum selling price, under the normal method of recovery, the G.P.P. is 99% (the stated maximum selling price of $10 million less adjusted basis of $100,000, divided by the contract price of $10 million). This results in a recognized gain for the year of the sale of $1,782,000 (99% of the $1.8 million down payment) and a recovery of only $18,000 out of the total $100,000 basis.

However, if the taxpayer could demonstrate that the current and recent profits of X have approximated $2 million a year, and there is no reason to anticipate a major increase in the total profits during the next ten years, the taxpayer can expect that the selling price will total $2 million (1% of $2 million equals $20,000 for a total of $200,000 over 10 years, plus the first-year payment of $1.8 million). Therefore, the taxpayer can submit a ruling requesting the use an alternative method of recovery.

In the ruling request, T may propose to use a G.P.P. of 95% based on the excess of the expected selling price of $2 million over the adjusted basis of $100,000, divided

5 Code §1274 related to debt instruments issued for property.

by the expected total price of $2 million). Under this method, T would recover $90,000 of the total $100,000 basis in the year of sale and 5% of each payment received up to a maximum of $10,000 over the next ten years. The I.R.S. should allow this request because T's proposed alternative method allows for a reasonable basis recovery which is at least twice as fast as under the normally applied method.

Recent Private Letter Rulings

In four very similar ruling requests, the I.R.S. approved the use of an alternative recovery method. The rulings deal with a merger where shareholders of the target corporation were paid a specified sum at closing and three additional payments in subsequent years. The subsequent payments were to be valued under a formula in which an agreed amount was specified (*viz.*, $X) but was to be adjusted by fluctuations in the value of the acquiring corporation's publicly-traded shares. As the shares increased or decreased in value from the acquisition date to the payment date, the installment payments would fluctuate, as well. As matters turned out, the acquiring corporation's stock price dropped in value immediately following the merger so that by the time the first deferred payment was due, it was reasonable to anticipate that the regular applicable basis recovery method would result in substantial and inappropriate basis recovery deferral – the initial payment at the time of the merger turned out to represent a greater percentage of overall considerations than originally forecast. The taxpayers timely applied for a ruling and the I.R.S. approved.[6]

The rationale of the I.R.S. was as follows:

- Code §453(a) provides that income from an installment sale is to be taken into account under the installment method of accounting.
- Code §453(j)(2) authorizes the I.R.S. to prescribe regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained. The transaction involving the merger was just such a transaction, as the final price was adjustable based on share value fluctuations.
- Treas. Reg. §15A.453-1(c)(7)(ii) provides that a 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 recover of basis, the taxpayer must show (i) that the alternative method is a reasonable method of ratably recovering basis, and (ii) 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.

Based on share prices at the time of the first installment, the taxpayers in the ruling expected to receive substantially reduced payments. In support of its position, the taxpayer submitted a table indicating the basis recovery calculations that were

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[6] See, for example, P.L.R. 201626009, 06/24/2016.

used in the year of the sale, prepared under the assumption that share price would remain stable, and comparing that recovery schedule with an adjusted schedule based on the actual downward movement in share price. The following items were taken into account in the table:

- Beginning basis
- Amounts received/estimated to be received annually
- Annual basis recovery
- Ending basis
- Amount of basis deferred annually
- Percentage of total basis used annually

"As matters turned out, the acquiring corporation's stock price dropped in value immediately following the merger. . . . It was reasonable to anticipate that the regular applicable basis recovery method would result in substantial and inappropriate basis recovery deferral."

Under the facts, the I.R.S. ruled that the taxpayer's proposed alternative basis recovery method was a reasonable method of ratably recovering basis, and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate more than twice as fast as the rate at which basis would be recovered under the normal basis recovery rules. Accordingly, the taxpayer's use of the proposed alternative method of basis recovery was approved.