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by Eric B. Sloan and James Jennings

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In this report, Sloan and Jennings examine a four-step structure involving the use of installment obligations as a way to allow S corporation shareholders to roll and sell their interests disproportionately from one another without triggering tax to the rolling shareholders.

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He may not have been right about everything (or even most things), but Lindsey Buckingham was at least correct when he famously, if unintentionally, advised generations of S corporation shareholders that they actually *could* go their own way in a merger and acquisition transaction (rather than being forced to sell or roll proportionately).[1]

Suppose you represent a private equity firm that wants to have one of its portfolio companies acquire a business that is operated as an S corporation. The S corporation has two shareholders, Rolland and Selena. Rolland is a young hotshot in the industry, and part of the deal is that he will take over management of the combined business. Selena, however, is ready to retire and has already earmarked her 70 percent of the sales proceeds for a yacht. In an ideal world, Rolland would "roll" (that is, exchange his interest in the business for interests in the buyer in a tax-free transaction), and Selena would sell her interest in the business for cash. In an even more ideal world, your client's portfolio company would receive a basis step-up, at least for Selena's portion.[2]

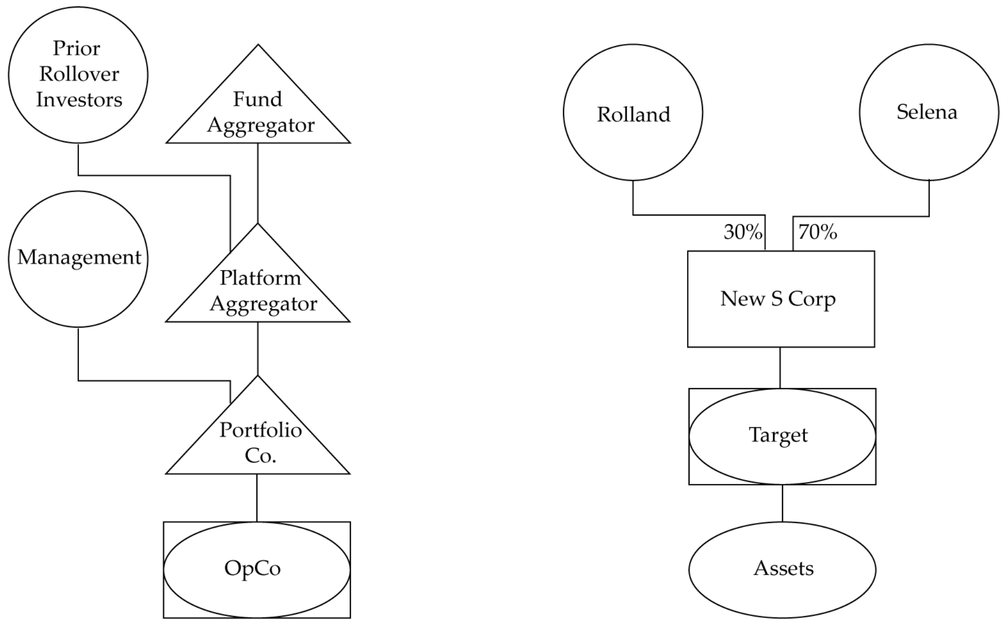
This conundrum has plagued many practitioners — not to mention S corporation shareholders, who have either had to roll more than they wanted or suffer an entirely or partially taxable rollover.[3] Fortunately, there is a

[1] Music critics and historians typically interpret Fleetwood Mac's "Go Your Own Way" (written by Buckingham) as a rumination on his breakup with Stevie Nicks, though there is, of course, no evidence that the song wasn't intended as unlicensed (if metaphorical) legal advice regarding the difficulties that sometimes arise in S corporation merger and acquisition transactions.

[2] Rolland and Selena obtained their shares in the company in exchange for contributions of cash (and no other property or services) at the time it was formed. Also, helpfully, the business and its assets were created sufficiently recently that the anti-churning rules of section 197(f)(9) are not relevant.

[3] This problem is well-understood and much discussed. *See, e.g.*, Gerald David August and Stephen R. Looney, "Electing Subchapter S: Benefits and Perils for the Unwary — Asset Sales, Stock Sales and Mergers" (2015) (American Law Institute continuing legal education course materials); and Michael P. Spiro, "Tax-Deferred Management Rollovers in Acquisition of Pass-Through Entities," 110 *J. Tax'n* 345 (2009).

Figure 1



surprisingly simple solution that, with the right facts, can accomplish most, if not all, of the desired outcomes.

Consider the following (fairly typical) structure for an S corporation transaction. In Figure 1, the S corporation has already undergone a "drop and convert" F reorganization.[4]

Often, the parties address the disparate treatment of shareholders like Rolland and Selena by compromising. That is, the parties would have New S Corp sell more than Rolland wants and roll more than Selena wants.[5] Under the resulting structure, New S Corp would hold an interest in Platform Aggregator, and each of Rolland and Selena would receive some cash.[6]

As mentioned, however, there is a better structure that, in the right circumstances, gets Rolland and Selena much closer to where they want to be. This structure — which involves the use of installment obligations and, of course, some wonderfully complicated sections of the code — uses the four steps below (with the tax consequences of each step in italics). The tax consequences are discussed in more detail in sections II, III, and IV of this report.

1. **Adoption of plan of liquidation.** New S Corp adopts a plan of liquidation.

No (immediate) tax consequences.

2. **Installment sale.** After adopting the plan of liquidation, New S Corp sells all the membership interests in Target to

[4]For a discussion of the drop-and-convert F reorganization, see Rev. Rul. 2008-18, 2008-1 C.B. 674. Although a pre-acquisition F reorganization is in many ways the gold standard for S corporation M&A transactions, there are alternatives, including a section 336(e) or section 338(h)(10) election.

[5]The most extreme version of such a "compromise" is a taxable roll in which OpCo would purchase all of Target for cash, New S Corp would distribute the cash, and Rolland would purchase interests in Platform Aggregator for cash. An unfortunate result of this taxable roll is that Rolland either ends up with a lower percentage interest in Platform Aggregator (because he needs to retain cash to pay taxes) or pays the resulting tax liability with other proceeds (or other cash on hand).

[6]Occasionally, sellers like Rolland will be given an interest that is intended to be a profits interest (*see* Rev. Proc. 93-27, 1993-2 C.B. 343), with the goal of bringing them up to the percentage interest that they would have had if they had rolled tax free (sometimes the profits interest includes a catch-up feature). For a good overview of profits interests, see Glenn Mincey, Eric Sloan, and Sheldon Banoff, *The Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, section 112 (Supp. 2023).

OpCo in exchange for two notes (the sale). The first note is payable in a single lump sum on the 10th anniversary of the closing (with interest paid annually). The second note is payable 90 percent on the third business day after closing and the remaining 10 percent on January 1 in the year after the closing occurs. Each note has market standard terms and bears interest at the market rate.

Because each note is an installment obligation, the sale is an installment sale under section 453 (except to the extent of some exceptions that are discussed below). Section 453(a) provides that in an installment sale, the seller generally is required to take the recognized gain into account over the period during which the installment payments are received (rather than including the entire amount of gain in its gross income in the year of the sale). New S Corp therefore does not take any gain into account when it receives the notes because it has not yet received any payments. OpCo, on the other hand, receives a full basis step-up in the assets of Target at the time of the sale.

3. **Liquidation of new S corp.** On the second business day after the sale, New S Corp liquidates under state law, distributing the 10-year note to Rolland and the shorter-term note to Selena.

Because the distribution occurs under a plan of liquidation adopted before the sale, sections 453B(h) and 453(h) apply to the liquidation. As a result, New S Corp does not recognize gain on the distribution of the notes (except for purposes of taxes imposed by subchapter S) under section 453B (h). Likewise, Rolland and Selena do not recognize gain on the receipt of the notes under section 453(h).

4. **Contribution to platform aggregator.** Immediately after the liquidation, Rolland contributes the 10-year note to Platform Aggregator in exchange for an interest in it.[7]

[7]Under the contribution agreement, Platform Aggregator covenants that it will not contribute the note to Portfolio Co. (or otherwise dispose of the note in a taxable transaction).

Under section 721(a), neither Rolland nor Platform Aggregator recognizes gain or loss when Rolland contributes the longer-term note to Platform Aggregator. Section 704(c)(1)(A) will apply regarding the note.[8] Selena recognizes gain when she receives the payments on her note (under section 453(a)).

By using this structure, the parties can (1) permit Rolland to roll into Platform Aggregator tax free (except to the extent the sale does not qualify for installment sale treatment), (2) permit Selena to be entirely cashed out (by January 1 of the next year), and (3) allow OpCo to obtain a fair market value basis in the assets of Target.[9]

Although one of the authors (no prizes for guessing which) has been explaining this structure to people for more than 20 years, as far as we can tell, it has, to date, rarely been used. Some of the building blocks of the structure, however, have been discussed by commentators[10] and the IRS.[11]

Of course, there are several technical hurdles — including some of the code's most abstruse related-party rules — that each of the sale, liquidation, and contribution must overcome to ensure the transaction structure achieves the intended result. We discuss each of these below.

I. Discussion of Technical Rules

A. The Sale

In the sale, New S Corp sells Target to OpCo for the two installment notes. See Figure 2.

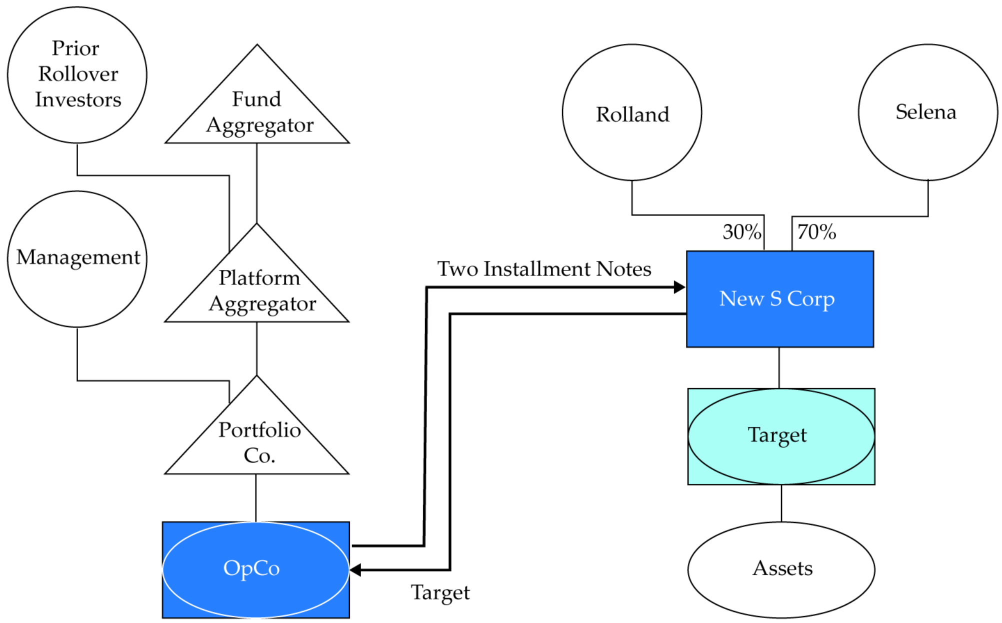
[8]Although, as discussed in Section II, section 704(c)(1)(A) causes Rolland to recognize the gain inherent in the note (*i.e.*, recognizing gain as the note is repaid), if the note were canceled, the other owners of Platform Aggregator could bear the burden of the cancellation of indebtedness income.

[9]As may be obvious from its inclusion in the "federal" edition of *Tax Notes*, this report is focused on federal income taxes. Although many states and localities follow the federal rules, an adviser would want to engage state and local counsel to ensure that there are no pitfalls.

[10]*See, e.g.*, Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* section 12.2 (1994) (describing a structure that can be used to convert an S corporation into a partnership).

[11]*See, e.g.*, LTR 200551018, in which an S corporation owned 90 percent by B and 10 percent by C purchased the assets of an S corporation that was owned 50 percent by each of A and B (Old Holdco) for two installment notes. Old Holdco then liquidated and distributed the installment notes to A and B. Interestingly, the IRS did not address the possibility that the transaction was a reorganization under section 368(a)(1)(D) (which appears to have been the case on the facts presented in the ruling).

Figure 2



For this structure to achieve the intended result, the sale must, at least in large part, qualify for the installment method under section 453.[12] This is because, if it does not qualify, New S Corp takes the gain into account at the time of the transaction rather than at the time the note is repaid (and the shareholders are allocated that gain in proportion to their ownership of New S Corp).

The good news is that the requirements of section 453 are relatively easy to satisfy. When a taxpayer disposes of property in a transaction that qualifies as an installment sale, the installment method of accounting generally requires the taxpayer to take the recognized gain into account over the period during which the installment payments are received (rather than including the entire amount of gain in its gross income in the year of the sale).[13] A disposition of property is an installment sale if it is "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs,"[14] and no exception applies to prevent the disposition from qualifying as an installment sale. If a disposition qualifies as an installment sale, the installment method automatically applies to that disposition (except if an exception applies) unless the taxpayer elects out of installment reporting.[15]

[12]For a more detailed discussion of the installment method and installment obligations generally, see Lisa M. Starczewski, *Installment Sales (Portfolio 565)*; W. Eugene Seago, "Shareholder Debt and Installment Sale of Intangibles," *Tax Notes Federal*, Aug. 22, 2016, p. 1143; James R. Hamill, "Purchases and Sales Involving S Corporations," 92 *Taxes* 65 (2014); and Bryan P. Collins and Carol Kulish, "Selected Issues Arising With Respect to the Use of Installment Obligations in Corporate Acquisitions of S Corporations," 8 *J. S. Corp. Tax.* 3 (1997).

[13]Section 453(a). A taxpayer can elect out of using the installment method by reporting an amount realized equal to selling price (including the full face amount of any installment obligation) on the tax return filed for the tax year in which the installment sale occurs or in the manner prescribed by appropriate instructions for the taxpayer's tax return. Reg. section 15a.453-1(d)(3). The installment method applies only to gains; if an installment sale results in a loss, the entire loss is taken into account in the year of the sale. Rev. Rul. 70-430, 1970-2 C.B. 51. See Section II of this report for a discussion of the interest rules of section 453A.

[14]Section 453(b)(1).

[15]Section 453(d)(1).

In the sale, each of the two notes includes at least one payment to be received after the close of the tax year in which the sale occurs.[16] As a result, the installment method is applicable, except to the extent that any of the exceptions discussed below applies to the sale.[17]

There are several statutory and regulatory exceptions that make a transaction ineligible for the installment method in whole or in part.[18] These exceptions cover a wide range of aspects of a transaction, including the types of assets sold; the status of, or relationship between, the seller and buyer; the structure of the sale; and the treatment of liabilities. If a single transaction includes a disposition of some property that is eligible and some that is not, the sale is treated in part as an installment sale and in part as not.[19] Because of the number and scope of these exceptions, it is likely that any merger and acquisition transaction will implicate at least one. Each of these exceptions is discussed below.

1. Dealer dispositions.

Under section 453(b), the term "installment sale" does not include a dealer disposition,[20] which is any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on "the installment plan,"[21] or any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.[22] There are limited exceptions to the dealer dispositions rule for farm property and certain sales of timeshares or residential lot land.[23]

2. Dispositions of inventory.

Under section 453(b), the term "installment sale" does not include a disposition of personal property of a kind that is required to be included in the inventory of a taxpayer if on hand at the close of the tax year.[24] Thus, the installment method cannot be used to report gains from sales of inventory.[25] Certain sales of property that generally would constitute inventory may still be eligible for the installment method if the property is sold outside the ordinary course of the taxpayer's business.[26]

3. Publicly traded property.

The installment method cannot be used for the sale of stocks or securities that are traded on an

[16]You might be wondering whether a sale that requires payment in one lump sum in a future tax year would be an installment sale. This is a fair question — after all, one might argue that there are no installments if there is just a single payment. Fortunately, the regulations clarify that: "The term 'installment sale' includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale." Reg. section 15a.453-1(b)(1).

[17]If an installment obligation does not have adequate stated interest (within the meaning of reg. section 1.483-1(a)), section 483 operates to impute interest.

[18]Some of these exceptions operate by preventing the disposition from qualifying as an installment sale (for example, the dealer disposition exception), while others operate by treating the disposition as part of an installment sale but making the disposition ineligible for the installment method of reporting (for example, the publicly traded property exception). The effect of either type of exception, however, is to make the installment method unavailable to the extent it applies, as discussed in more detail below.

[19]*See* the preamble to the final reg. section 1.453-11 regulations. T.D. 8762, 63 F.R. 4168, 4169 (Jan. 27, 1998) ("If an installment obligation arises from both a sale or exchange of inventory, etc. . . . and a sale or exchange of other assets, the portion of the installment obligation that is attributable to the sale or exchange of other assets is a qualifying installment obligation.").

[20]Section 453(b)(2)(A).

[21]Section 453(l)(1)(A). Although section 453 does not elaborate on the meaning of the phrase "on the installment plan," reg. section 1.453A-1(c)(3) and (d) elaborate on the meaning (which essentially is any sale of personal property under any plan (other than a revolving credit plan, discussed below) that contemplates the sale's or sales' being paid for in two or more installments (and, in certain cases, the payments actually are made in two or more payments)). Reg. section 1.453A-1(d) notes that a traditional installment plan usually involves the retention of a security interest in the property sold by the dealer.

[22]Section 453(l)(1)(B).

[23]Section 453(l)(2).

[24]Section 453(b)(2)(B). As discussed later, the IRS takes the position that a sale of a partnership interest may not be reported under the installment method to the extent the gain is attributable to inventory (within the meaning of section 751(d)). Rev. Rul. 89-108, 1989-2 C.B. 100. Because this ruling predates the removal of the "substantially appreciated" requirement in section 751(a) under the Taxpayer Relief Act of 1997, this ruling ought to be interpreted without regard to the "substantially appreciated" requirement.

[25]*See, e.g., King Solarman Inc. v. Commissioner*, T.C. Memo. 2019-103 (holding that section 453(b)(2)(B) precludes use of the installment method by a manufacturer of solar equipment because the manufacturer was required to maintain inventories for equipment; solar towers sold by the manufacturer were personal property of a kind required to be included in inventory if on hand at the close of the tax year).

[26]*See, e.g., Andrew Crispo Gallery Inc. v. Commissioner*, 86 F.3d 42 (2d Cir. 1996), *vacating* T.C. Memo. 1994-563 (artwork that was seized by the IRS to be sold at auction to satisfy tax liens was not inventory because it was not held by gallery for sale to customers in the ordinary course of trade or business; therefore, the gallery may use the installment method to account for gain on the sale of the artwork).

established securities market or other property of a type regularly traded on an established market.[27] The IRS has issued a number of letter rulings regarding situations in which stocks or securities will be considered publicly traded.[28] Treasury has the authority to promulgate regulations disallowing the use of the installment method, in whole or in part, for transactions in which the restrictions barring use of the installment method for sales of publicly traded property (or revolving credit sales) would be avoided by use of related parties, passthrough entities, or intermediaries.[29] The regulations would apply to sales of property in which a substantial portion of the property's value is attributable to gain from property that is ineligible for installment method reporting.[30] No such regulations have been promulgated.[31]

4. Depreciation recapture.

The installment method cannot be used for any depreciation recapture under section 1245 or 1250 (and so much of section 751 as relates to sections 1245 and 1250).[32] Any such income is recognized in the year of the sale.

5. Sales of depreciable property to related persons.

Under section 453(g), the installment method generally is not available if the disposition is a disposition of depreciable property between related persons as defined in section 1239(b) or section 707(b)(1)(B).[33] For this purpose, depreciable property means property "of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in section 167."[34]

As promised earlier, applying section 453(g) requires one to wade through some of the code's most difficult related-party rules. Very generally, sections 1239(b) and 707(b)(1)(B) treat as related persons (1) a person and any entity directly or indirectly owned by that person and (2) any two or more entities that are under common ownership (in each case, with a more-than-50-percent threshold). In determining whether two persons are related under section 1239(b), "ownership shall be determined in accordance with rules *similar to* the rules under section 267(c)" other than section 267(c)(3)) (emphasis added).[35]

It is possible, if you are so inclined, to take a deep dive into the legislative history of, and guidance interpreting, section 1239 and section 267 to clear up ambiguities that include (1) exactly which portions of the test include "common ownership" elements,[36] (2) the extent to which

[27] Section 453(k).

[28] LTR 9306001 (regarding stock convertible into publicly traded stock); LTR 9306003 (same); LTR 9803009 (regarding stock that is substantially similar to stock that is traded on an established securities market); LTR 9803021 (same); LTR 9803022 (same); LTR 200226039 (regarding unregistered stock in a corporation that has other publicly traded stock).

[29] Section 453(k) (flush language).

[30] S. Rep. No. 99-313, at 131 (1986) (discussing the regulations to be issued and providing the following example: "If a taxpayer sells his interest in a wholly owned corporation the only assets of which are stock or securities that are traded on an established securities market, the Secretary of the Treasury may deny the use of the installment method to account for gain on the sale.").

[31] For the leading discussion of the impact of "spurned delegations" of regulatory authority, see Phillip Gall, "Phantom Tax Regulations: The Curse of Spurned Delegations," 56 *Tax Law.* 413 (2003); *see also* Amandeep S. Grewal, "Substance Over Form? Phantom Regulations and the Internal Revenue Code," 7 *Hous. Bus. & Tax J.* 42 (2006).

[32] Section 453(i).

[33] Section 453(g)(1) and (3). Section 453(g)(2) provides that section 453(g) does not make the installment method unavailable "if it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of federal income tax." For a discussion of the "satisfaction of the Secretary standard" in other contexts, see, *e.g.*, Thomas F. Wessel et al., "Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings" (2020); John Gamino, "Tax Controversy Overburdened: A Critique of Heightened Standards of Proof," 59 *Tax Law.* 497 (2006).

[34] Section 453(f)(7).

[35] Section 1239(c)(2). Although section 1239(c)(2) does not elaborate on the meaning of "similar," the IRS's analysis generally has assumed that the rules are the same as section 267(c) (other than section 267(c)(3)). *See*, *e.g.*, LTR 200133030 (applying section 267(c) in the context of section 1239 without modification other than disregarding section 267(c)); and LTR 200602018 (same). Curiously, and incorrectly, in LTR 200133030, the IRS analyzes relatedness under all the provisions of section of 267(b), rather than only under paragraphs (3), (10), (11), and (12) as specified in section 1239(c).

[36] Section 1239(c)(1)(A) and (B) do not, but (C) does. In particular, the legislative history to the Tax Reform Act of 1986 demonstrates that Congress believed that the phrase "a person and all entities more than 50 percent owned, directly or indirectly, by that person" does not include "entities more than 50 percent owned, directly or indirectly, by the same persons." Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 361 (May 4, 1987).

section 267(e) is applicable for the constructive ownership rules,[37] and (3) whether reg. section 1.267(b)-1(b) could operate to recharacterize a transaction in a manner that treats the parties as related.[38]

Another possible (and entertaining) diving expedition can be found in the "time for testing" question — that is, what is the appropriate time to determine whether there is a relationship between the parties? The Court of Claims addressed the issue in 1980 in *Robishaw*, holding that the time for testing was immediately before the transaction.[39] In *Robishaw*, the court explained that the time for testing was before the transaction because:

> section 1239 of the 1954 Code involved here is concerned with the relationship existing between a stockholder and a corporation and the power of the stockholder to influence the corporation in connection with a transaction involving a sale of property by the stockholder to the corporation, or vice versa, it seems only logical to conclude that the significant thing is the relationship existing when the negotiations are in progress and an agreement is reached, rather than the relationship existing after the consummation of the transaction.[40]

Although the *Robishaw* court's reasoning is consistent with the terminology in section 1239 ("controlled entities"), it is not entirely consistent with the substance of the provision. That is, the substance of section 1239 relates largely to the percentage of value owned, not the percentage of vote, and it seems unlikely that Congress would have neglected to mention voting power if, as the court in *Robishaw* suggests, Congress had been focused solely on "the power of the stockholder to influence the corporation."

Then, in 1986, the IRS and Treasury weighed in on the "time for testing" question by promulgating regulations that provided that when the transferor is an entity, the time for testing relationships is both immediately before and immediately after the transfer.[41] The preamble to those regulations explains that the holding in *Robishaw* is not followed.[42] Because reg. section 1.1239-1 has not been updated to reflect the five most recent amendments to section 1239, it may well be that the regulation is no longer valid (at least in part).[43] Nevertheless, when structuring a transaction like the rollover described above, it is worth considering the time for testing question.

One final structural question worth considering is whether reg. section 1.453-11(a)(2) could apply, in effect, to treat the transaction as a purchase by OpCo of the stock of New S Corp. As we discuss in more detail later, reg. section 1.453-11(a)(2) provides that when a shareholder receives an installment obligation in a section 331 liquidation, the "*shareholder* treats [the] installment obligation, for all purposes of the Internal Revenue Code, as if the obligation is received by the shareholder from the person

[37] Not for purposes of section 1239(c)(1)(A) and (B), though arguably for purposes of section 1239(c)(1)(C). In section 1239(c)(2), Congress specifically addressed which constructive ownership rules are applicable for purposes of section 1239; if Congress wanted section 267(e) to apply, it would have said so. Arguably, the reference to section 267(b)(3), (10), (11), and (12) sweeps in the other rules of section 267, but that strikes us as a fairly weak argument in light of the specificity of section 1239(c)(2).

[38] Probably not, but it is worth thinking about (for the same reason as discussed *supra* note 35). Reg. section 1.267(b)-1(b) arguably was statutorily obsoleted by changes to the code that have occurred since 1982. *See* Jennifer H. Alexander and Colleen McHugh, "Sections 267 and 707: Are Related Party Transactions Leaving You at A Loss?" 26 *Prac. Tax Law.* 37 (2011-2012). We note, however, that those statutory changes are not entirely coextensive with reg. section 1.267(b)-1(b), and the IRS has applied the regulation since the 1986 amendment to section 707(b)(1)(A). *See* LTR 201138015 (applying reg. section 1.267(b)-1(b) without discussion of whether the regulation is still applicable under current law).

[39] *Robishaw v. United States*, 616 F.2d 507 (Ct. Cl. 1980).

[40] *Id*. at 514-515. The court cited as support two cases interpreting what is now section 267: *W.A. Drake Inc. v. Commissioner*, 145 F.2d 365 (10th Cir. 1944); and *Federal Cement Tile Co. v. Commissioner*, 338 F.2d 691 (7th Cir. 1964). In each case, the taxpayer owned more than 50 percent of a corporation before, and less than 50 percent after, a transaction. Those courts held that the relevant question in each case was the ownership before the transaction.

[41] T.D. 8106. Interestingly, the time for testing when the transferor is not an entity is only after the sale. Reg. section 1.1239-1(c)(3) ("(i) If the transferor is an entity, the transferee and such entity are related if the entity is an 80-percent owned entity with respect to such transferee either immediately before or immediately after the sale or exchange of depreciable property, and (ii) If the transferor is not an entity, the transferee and such transferor are related if the transferee is an 80-percent owned entity with respect to such transferor immediately after the sale or exchange of depreciable property.").

[42] Preamble to T.D. 8106, 51 F.R. 42835 (Nov. 26, 1986). Although the preamble does not elaborate, presumably the IRS and Treasury took the position that *Robishaw* was overturned by one of the many amendments in the intervening years or was incorrect as a matter of law.

[43] The "time for testing" regulations finalized (with modifications) regulations that the IRS and Treasury had proposed in 1982. Prop. reg. section 1.1239-1. Curiously, although the final regulations were promulgated after TRA 1986, they do not take into account amendments to section 1239 that had been made in 1980, 1982, 1984, or 1986.

issuing the obligation in exchange for the shareholder's stock in the liquidating corporation" (emphasis added). Importantly, this regulation does *not* provide that the *transaction* is treated as a purchase of stock by the buyer; rather, by its terms, the regulation simply provides that the treatment *to the shareholder* is determined as if the obligation were received directly from the buyer in exchange for the stock. The language of the regulation and the text of the preamble explain that the intention of this provision is to ensure that "if the stock of a liquidating corporation is traded on an established securities market, an installment obligation received by a shareholder from that corporation as a liquidating distribution . . . does not qualify for installment reporting."[44] Reg. section 1.453-11(a)(2) similarly provides that "if the stock of a corporation that is liquidating is traded on an established securities market, an installment obligation distributed to a shareholder of the corporation in exchange for the shareholder's stock does not qualify for installment reporting pursuant to section 453(k)(2)."[45]

6. Revolving credit plans.

Section 453(k) provides that the installment method cannot be used to report gain on any disposition of personal property under a revolving credit plan.[46] Thus, all payments must be treated as received in the year of sale. A revolving credit plan is an arrangement under which a customer pays a portion of an outstanding balance each month (for example, a credit card).[47] The sale in our example is not made under a revolving credit plan, making section 453(k) inapplicable.

7. Interests representing income from services.

Courts have denied the use of the installment method when the gain from the sale of property is more properly characterized as income from the performance of services. For example, in *Sorensen*,[48] the taxpayer received transferable options in connection with an employment arrangement. The options were exercisable at a future date to purchase stock at a price that was 25 percent of the market price at the time that the employment arrangement was entered into. The taxpayer sold the options for cash and notes payable over several years and took the position that the gain could be reported under the installment method. The Tax Court found that the options were granted to the taxpayer as compensation for services, and it denied the use of the installment method, holding that the installment sale provisions apply to the reporting of the sale of property on the installment basis, not to the reporting of income from compensation for services. Similarly, in *Mingo*,[49] the taxpayer sold a partnership interest and applied the installment method to the gain, including proceeds attributable to section 751(c)(2) unrealized receivables representing rights to payment for services rendered. The Tax Court denied the use

[44] Preamble to T.D. 8762, 63 F.R. 4168, 4169 (Jan. 28, 1998).

[45] Moreover, if reg. section 1.453-11(a)(2) were to recharacterize the transaction as a sale of New S Corp by Rolland and Selena, that recharacterization would make section 453(g) inapplicable because the sale would not be a sale of depreciable property within the meaning of section 453(g) and would instead be a sale of stock. As a result, trying to interpret reg. section 1.453-11(a)(2) in a way that recharacterizes the entire transaction would entirely upend the carefully designed regime of section 453(g).

[46] Although the term "revolving credit plan" is not defined in section 453, former reg. section 1.453A-2(c)(1) provided that the terms and conditions of a revolving credit plan "contemplate that account balances may be paid in full or in installments." Moreover, that regulation explained that "it is generally impossible to determine that a particular sale under a revolving credit plan is to be or is in fact paid for in installments." That is not the case with the notes, for which it is *certain* that the sale will be paid for in installments.

[47] *Id*. Reg. section 1.453A-2 was removed from the Code of Federal Regulations in March 2019 (T.D. 9849) in response to Executive Order 13789 (Apr. 26, 2017), which directed Treasury to review and propose for deletion any unnecessary regulations. Treasury did not explain why former reg. section 1.453A-2 had been selected for deletion. Reg. section 1.453A-1(d)(2) continues to cross-reference reg. section 1.453A-2 notwithstanding the latter's removal from the CFR.

[48] *Sorensen v. Commissioner*, 22 T.C. 321 (1954). *Sorensen* predates current section 453 and the enactment of section 83, so although it is a useful illustration of the point, its continuing validity is unclear.

[49] *Mingo v. Commissioner*, 773 F.3d 629 (5th Cir. 2014), *aff'g* T.C. Memo. 2013-149.

of the installment method for the portion of the sale proceeds attributable to the partnership's unrealized receivables.[50] The Fifth Circuit, relying on *Sorensen*, affirmed the Tax Court's decision that a taxpayer may not report income from the sale of the taxpayer's interest in a partnership under the installment method to the extent that the income is attributable to unrealized receivables for services. According to the court, the proceeds from the sale of unrealized receivables for services are classified as ordinary income and do not arise from the sale of property. Those proceeds therefore do not qualify for the installment method. The decision in *Mingo* followed the IRS's reasoning in ILM 200722027.

8. Subsequent dispositions.

Under section 453(e), if a person disposes of property to a related person[51] and that related person later disposes of the property before the final installment has been paid to the original seller, any remaining installments effectively accelerate for tax purposes.[52] Under section 453(e)(2)(A), however, this rule applies only if the second disposition occurs within two years after the first disposition (except in the case of marketable securities[53] and certain option-like arrangements that reduce the original buyer's risk of loss).[54]

Although not relevant to the structure at hand, the marketable securities exception to this two-year presumption is somewhat curious and worthy of a brief detour. That is, section 453(k)(2) provides that all payments to be received regarding an installment obligation "arising out of a sale of stock or securities which are traded on an established securities market" are treated as received in the year of the sale. In most cases, therefore, section 453 would not be implicated by a later sale of a marketable security because the payments under the installment obligation would already have been accelerated (that is, taken into account in the year of the original sale) under section 453(k)(2). However, this rule would be implicated in a situation in which a corporation distributes an installment obligation in a section 331 liquidation. For example, if (1) a corporation sells a marketable security to a related buyer for a 10-year installment obligation, (2) the corporation distributes the installment obligation to a shareholder in a section 331 liquidation, and (3) the original (related) buyer sells the marketable security to a third party three years after the original sale, section 453(e)(1) and (2) would cause the installment obligation to accelerate, and any remaining payments would be treated as received at the time of the later sale (in year 3). This is because, under reg. section 1.453-11, an installment obligation received by a shareholder in a section 331 liquidation can be an installment obligation in the hands of the shareholder even if the corporation received the installment obligation for a sale of property described in section 453(k)(2).[55]

9. Excluded liabilities.

If a buyer assumes or takes property subject to any "qualifying indebtedness," that assumption (or taking subject to) is not treated as a payment

[50]The legal reasoning in *Mingo* is in meaningful tension with much of the law and fabric of subchapter K. Moreover, there is no evidence that Congress intended to exclude partnership interests from installment sale treatment to the extent attributable to unrealized receivables for services. For a discussion of the issues with the reasoning in *Mingo*, see Monte A. Jackel, "Partnership Aggregate-Entity Cases, Rulings, and Analysis," *Tax Notes Federal*, Mar. 27, 2023, p. 2089. *See also Rawat v. Commissioner*, T.C. Memo. 2023-14 (applying reasoning conceptually similar to *Mingo* to a partnership's inventory).

[51]The definition of related person for purposes of section 453(e) is broader than the definition for purposes of section 453(g). Under the applicable definition in section 453(f), a related person is (1) a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property; or (2) a person who bears a relationship described in section 267(b) to the person first disposing of the property.

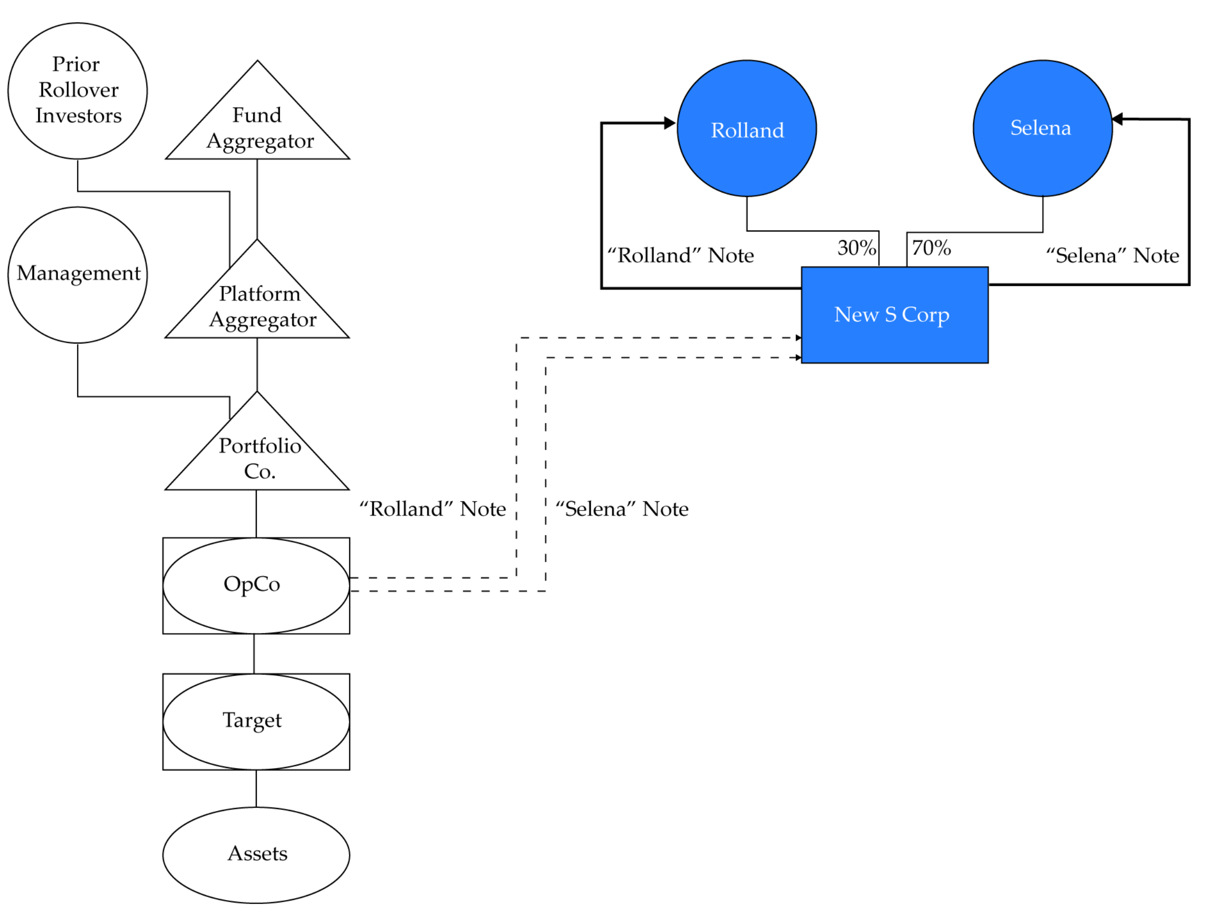
[52]Section 453(e)(1) ("The amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.").

[53]A marketable security is "any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise." Section 453(f)(2). It is unclear why Congress chose to use different terminology when addressing almost identical concepts in section 453(k) and section 453(e)(2).

[54]Section 453(e)(2)(B) provides that the running of the two-year period is tolled during any period in which the original buyer's risk of loss is diminished by holding a put right over the property (or similar property), another person's holding a call right over the property, or a short sale or any other transaction.

[55]Reg. section 1.453-11(c)(2) ("The fact that . . . the assets of a trade or business sold by the corporation for an installment obligation include . . . marketable securities . . . does not affect whether installment obligations received in exchange for those assets are treated as qualifying installment obligations by the shareholder.").

Figure 3



received in the year of sale for purposes of section 453, except to the extent that the amount of debt exceeds the seller's basis in the property sold (determined after adjusting for selling costs).[56] For this purpose, qualifying indebtedness means (1) "a mortgage or other indebtedness encumbering the property" and (2) "indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property."[57] To the extent a buyer assumes (or takes subject to) any liabilities other than qualifying indebtedness, the assumption (or taking subject to) is treated as an amount received in the year of the sale.

B. The Liquidation

In the liquidation, New S Corp liquidates, distributing the two notes to its shareholders, Rolland and Selena. See Figure 3.

Section 453B(a) provides that if an installment obligation is "distributed, transmitted, sold, or otherwise disposed of":

> Gain or loss will 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.

[56] Reg. section 15a.453-1(b)(3). An assumption, or taking subject to, includes an arrangement under which the seller's liability on qualifying indebtedness is eliminated incident to the disposition.

[57] Reg. section 15a.453-1(b)(2)(iv) ("The term 'qualifying indebtedness' does not include an obligation of the taxpayer incurred incident to the disposition of the property (*e.g.*, legal fees relating to the taxpayer's sale of the property) or an obligation functionally unrelated to the acquisition, holding, or operating of the property (*e.g.*, the taxpayer's medical bill).").

The flush language at the end of section 453B(a) provides that "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." Although section 453B(a) appears, at first glance, to result in an acceleration of the amounts due under the notes, there are several exceptions to this general rule that result in nonrecognition of gain or loss in certain transactions, including, importantly, the liquidation of an S corporation.

Under section 453B(h), if an S corporation distributes an installment obligation in a complete liquidation, the distribution generally does not result in gain or loss to the S corporation (that is, it is not a disposition under section 453(B) and does not trigger gain under section 336) if the receipt of the obligation is *not* treated as payment for the stock under section 453(h)(1). Section 453(h)(1)(A), in turn, provides that the receipt of an installment obligation by a shareholder in a liquidation to which section 331 applies is *not* treated as a receipt in payment for the stock if:

> The shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period.[58]

Stated differently, the receipt by a shareholder of an installment obligation from an S corporation is not taxable if (1) the S corporation received the installment obligation in a sale or exchange by the S corporation after adopting a plan of liquidation, (2) the distribution is made as part of a section 331 liquidation, (3) the plan of liquidation is adopted before the sale or exchange, and (4) that sale or exchange, the adoption of the plan of liquidation, and the liquidation all occur within 12 months. Our transaction satisfies these requirements because (1) New S Corp receives the notes in the sale (which occurs after the adoption of the plan of liquidation), (2) the liquidating distribution by New S Corp is a liquidation under section 331,[59] and (3) the sale, adoption of the plan of liquidation, and the liquidation happen within the required 12-month period.[60]

Although section 453B(h) is perfectly clear on this result, the careful practitioner might wonder whether they should be concerned that section 336(a) does not mention section 453B(h) (and vice versa). Indeed, given that Congress enacted section 453B(h) specifically to override section 336(a) for distributions of installment obligations by S corporations, it is strange that Congress did not see fit to acknowledge that intention and result in the text of at least one of those code sections. Fortunately, the legislative history clears up any potential confusion about how the two provisions interact. Section 453B(h) was enacted under section 1006 of the Technical and Miscellaneous Revenue Act of 1988 to allow the shareholder of an S corporation "to report the gain over the same period of years as if the amendments made by the 1986 Act had not been enacted."[61] The amendments to which the Senate report refers were some of the changes made as part of TRA 1986 to finish the project of *General Utilities* repeal. Specifically, before TRA 1986, section 337(a) provided that if a corporation adopted a plan of liquidation and then distributed its assets in a complete liquidation within the following 12 months, the corporation recognized no gain or loss on any sales of property during that 12-month period. Correspondingly, then-current section 453B(d)(2) provided that if (1) a corporation distributed an installment obligation in connection with a section 337 liquidation, and (2) no gain or loss would have been recognized by

[58] Section 453(h)(1)(A). Instead, if section 453(h) applies, the receipt of payments made under the installment obligation are treated as the receipt of payment for the stock. Section 453(h)(1) and reg. section 1.453-11(a) (which interprets section 453(h) but does not provide specific rules for section 453B(h)).

[59] A liquidation qualifies as a complete liquidation under section 331 if (1) it is a distribution in redemption of all the stock of a corporation "pursuant to" a plan, and (2) not more than 80 percent of the stock of the liquidating corporation is owned by a corporation. Although section 331 does not actually require distributions be made pursuant to a plan, unless the corporation liquidates entirely on one day, the absence of a plan makes it difficult to prove that earlier distributions were part of the liquidation rather than distributions under section 301.

[60] The IRS will not normally issue a ruling or determination letter on the tax effects of a corporate liquidation made over more than three years. Rev. Proc. 2023-3, 2023-1 IRB 144, section 4.01(26). The liquidation qualifies as a complete liquidation under section 331 because it is a distribution in redemption of all the stock of the corporation under a plan, and none of the stock of New S Corp (*i.e.*, not more than 80 percent) is owned by a corporation.

[61] S. Rep. No. 100-455, at 66 (Aug. 11, 1988).

the corporation under section 337 if it had sold the installment obligation during the 12-month period following the adoption of the plan of liquidation, then the distribution was not a taxable disposition of the installment obligation. Finally, before its amendment in 1986, section 336(a) provided that "except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation" (emphasis added). As a result of these three code provisions, before TRA 1986, a corporation could adopt a plan of liquidation, sell its assets for an installment obligation, and distribute the installment obligation to its shareholders without accelerating the gain inherent in the installment obligation (or in the shareholder's stock).

Section 453B(h) was enacted (with retroactive effect) specifically to restore the pre-TRA 1986 state of affairs for S corporations (but not C corporations). The IRS and Treasury explained the interaction of sections 336 and 453B(h) in the preamble to reg. section 1.453-11 regulations promulgated in 1998:

> Under section 453B, the disposition of an installment obligation generally results in the recognition of gain or loss to the transferor. Thus, in accordance with sections 453B and 336, a C corporation generally recognizes gain or loss upon the distribution of an installment obligation to a shareholder in exchange for the shareholder's stock, including complete liquidations covered by section 453(h). . . . In the case of a liquidating distribution by an S corporation, however, section 453B(h) provides that if an S corporation distributes an installment obligation in exchange for a shareholder's stock, and payments under the obligation are treated as consideration for the stock pursuant to section 453(h)(1), then the distribution generally is not treated as a disposition of the obligation by the S corporation. Thus, except for purposes of sections 1374 and 1375 (relating to certain built-in gains and passive investment income), the S corporation does not recognize gain or loss on the distribution of the installment obligation to a shareholder in a complete liquidation covered by section 453(h).[62]

As noted in the preamble, section 453B(h) provides that despite the general rule of section 453B that the distributing S corporation does not recognize gain or loss, gain or loss is recognized for purposes of taxes imposed by subchapter S (but only for purposes of those taxes, which are limited to the built-in gains tax under section 1374 and the excess net passive income tax under section 1375). One might question whether the "last-in, first-out recapture" tax under section 1363(d) should be included in this list, though that provision quite arguably does not "impose" a tax.

There are two (fairly limited) exceptions that can cause a distribution of an installment obligation that meets the requirements of section 453B(h) to be "in payment for the stock" such that the distribution is a disposition that accelerates the installment obligation. Neither is applicable to our liquidation.

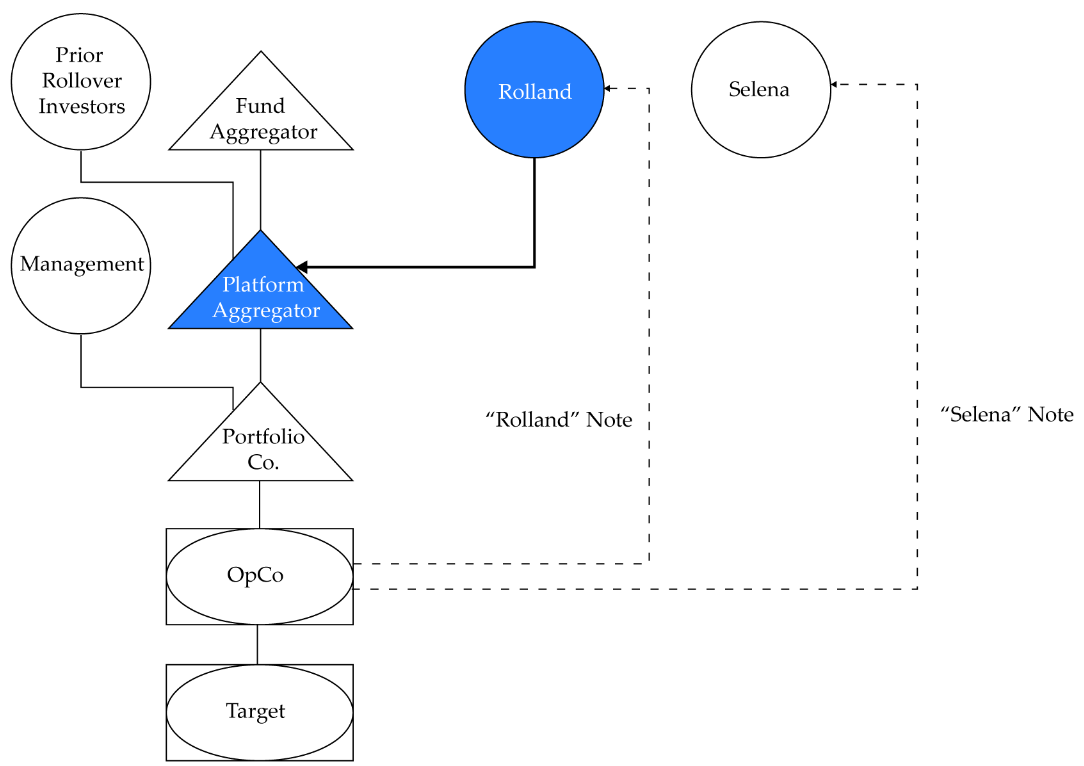
First, a distribution of an installment obligation is treated as in payment for the stock if the S corporation acquired it in a sale or exchange of inventory "unless such sale or exchange is to 1 person in 1 transaction and involves substantially all of such property attributable to a trade or business of the corporation."[63] In many mergers and acquisitions transactions, the business's inventory is sold to the buyer in a single transaction, and as a result, the distribution of the installment obligation is not treated as in payment for the stock.

As with the marketable securities exception discussed earlier, it is curious that this provision includes a bulk sale exception for inventory when a sale of inventory generally does not qualify as an installment sale under section 453(b)(2)(B). The explanation likely is the same as the reason for the marketable security exception: Congress intended that (1) a sale of inventory by a corporation not be eligible for the installment method but that (2) the corporation be able to distribute the installment obligation received in exchange for the inventory to a shareholder in a transaction that is eligible for

[62]T.D. 8762.

[63]Section 453(h)(1)(B).

Figure 4



the favorable treatment provided in section 453(h).[64]

Second, a distribution of an installment obligation is treated as in payment for the stock if the S corporation's receipt of it is "attributable to the disposition by the corporation of depreciable property," but only if the obligor under the installment obligation and the shareholder receiving the distribution are married to each other or are otherwise related persons (within the meaning of section 1239(b)).[65] This related-party analysis is largely the same as the analysis above regarding the application of section 453(g), except that the question is whether Portfolio Co., on the one hand, and either of Rolland and Selena, on the other, are related under section 1239(b), as opposed to whether OpCo and New S Corp are related.[66] In most M&A transactions between unrelated persons, the buyer and the liquidating S corporation will not be related, and the distribution of the installment obligation will therefore not be treated as in payment for the stock.

C. The Contribution

Finally, in the contribution, Rolland will contribute the note that he received in the liquidation to Platform Aggregator in exchange for an interest in Platform Aggregator. See Figure 4.

The contribution is a tax free contribution of property to a partnership under section 721(a). As anyone who has written an opinion addressing

[64]In this regard, we note that section 453(h)(1) requires the corporation to have received an installment obligation "in respect of a sale or exchange" and does not specifically require that sale of exchange to have been an installment sale. For an S corporation, however, that rule is not particularly helpful because the sale of the inventory by the S corporation might well result in gain (that generally would be characterized as ordinary income) in the year of sale that would be allocated to the shareholder.

[65]Section 453(h)(1)(C).

[66]For several good discussions of related-party and constructive ownership rules generally, see Robert Willens, "Navigating the Constructive Ownership Rules," *Tax Notes Federal*, Apr. 10, 2023, p. 293; Jasper L. Cummings, Jr., "Attribution Rules in Times of Loss," *Tax Notes Federal*, July 13, 2020, p. 205; Patrick C. Gallagher, "Ownership Attribution Rules, 'Relatedness' and Large Partnerships," The Tax Club (2011); Willens, "Exceptions to the Application of the Attribution Rules: Few and Far Between," *Tax Notes*, Nov. 14, 2005, p. 923; and Gary B. Mandel, "The Option Attribution Rules of the Internal Revenue Code," 73 *Taxes* 121 (Mar. 1995).

the application of section 721(a) knows, it is often hard to say what constitutes "property" for this purposes. Fortunately, however, reg. section 1.721-1(a) specifically includes an "installment obligation" as a type of property.[67]

There are, of course, a handful of exceptions to section 721(a) that must be considered, including section 721(b), section 721(c), and section 707. Although it is unlikely that any of those exceptions would apply to a transaction like this, it is worth observing that an installment obligation that is debt constitutes an investment asset for purposes of section 721(b) because an investment asset includes "evidences of indebtedness."[68] In general, if OpCo does not have meaningful investment assets, it is unlikely that section 721(b) would apply. This is because, in determining whether Platform Aggregator would be an investment company if it were a corporation, an interest in a lower-tier partnership is characterized using rules similar to those that apply for purposes of section 731(c)(2).[69]

Because the contribution is a tax-free contribution to a partnership under section 721(a), it is not a taxable disposition of the note under section 453B. In particular, reg. section 1.453-9(c) provides that a contribution to a partnership that qualifies as tax free under section 721(a) is not a taxable disposition of the note under section 453B unless the contribution results in the satisfaction of the note. Although (unlike with the liquidation) the code does not specifically include an exception to section 453B for tax-free contributions, reg. section 1.453-9(c) provides for certain exceptions for dispositions in which no gain or loss is recognized. Specifically, under reg. section 1.453-9(c)(2):

> Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

In Rev. Rul. 73-423, 1973-2 C.B. 161, the IRS held that reg. section 1.453-9(c)(2) does not apply to nonrecognition transactions that result in the satisfaction of the installment obligation (this would include, for example, a contribution of a note receivable to an entity that holds the note payable). Because the contribution in our example is tax free under section 721(a) and does not result in the satisfaction of the note, it is not a taxable disposition of the note under section 453B and does not result in recognition of gain or loss.

One might wonder whether reg. section 1.453-9(c)(2) is still valid given that it was promulgated under former section 453(d) before that subsection was repealed and reenacted as section 453B.[70] It is. Among the evidence for this are the facts that (1) the IRS has continued to apply the rule in reg. section 1.453-9(c)(2) in the years following the repeal and replacement of section 453(d),[71] and (2) the IRS and Treasury have

[67] Reg. section 1.721-1(a) was promulgated in 1956 (as one of the original regulations under subchapter K). T.D. 6175. When the regulation was promulgated, therefore, the installment sale rules were quite different than they are today. It is thus possible to fall down a deep rabbit's hole wondering whether changes between then and now somehow change the rule in reg. section 1.721-1(a). Thankfully, though, one can comfortably conclude that the answer is no without going all the way down, through, and out the other side of that rabbit's hole. The IRS and Treasury clearly intend that an installment obligation (within the meaning of *current* section 453) be treated as property of a kind that can be contributed to a partnership or corporation tax free under section 721(a) or section 351(a) (as evidenced by the portions of reg. section 1.453-9(c)(2) and prop. reg. section 1.453B-1(c) that address section 721(a) and section 351(a)).

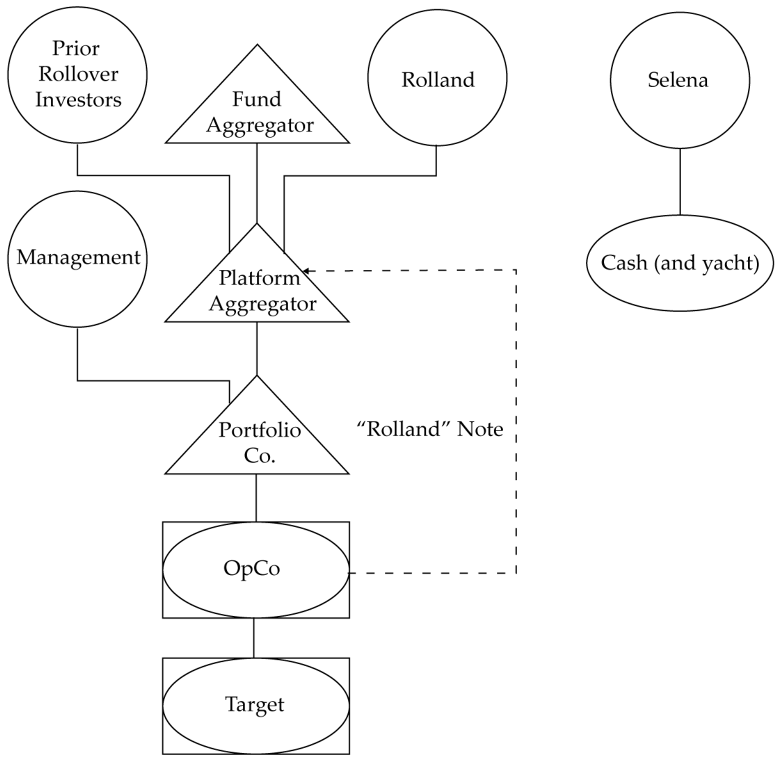
[68] Section 351(e)(1)(B)(ii).

[69] S. Rep. No. 105-33, at 7 n.69 (1997); JCT, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 184 n.204 (Dec. 17, 1997). The IRS has issued private letter rulings that, on the facts of those rulings, appropriately looked through a partnership to its assets to determine that an upper-tier partnership was not an investment partnership when the lower-tier partnership owned an operating business. The same result could have been reached by hewing to the legislative history test. In each case, though, it was necessary to disregard the fact that the lower-tier partnership was publicly traded because publicly traded partnership interests are listed investment assets. *See, e.g.*, LTR 201633028 and LTR 201547003.

[70] Installment Sales Revision Act of 1980, section 2(a).

[71] LTR 9620020.

Figure 5



indicated in proposed regulations that they intend the rules of reg. section 1.453-9(c)(2) to continue to apply.[72] The proposed regulations also adopt the conclusion of Rev. Rul. 73-423 and therefore do not apply to a nonrecognition transaction in which the installment obligation is satisfied.

II. Living With the Structure

After the transaction, the structure is as shown in Figure 5. There are a number of ongoing issues to consider, some of which are discussed below.

A. Recognition of Gain: Installment Method

Upon and after the contribution, Portfolio Aggregator will use the installment method to take into account the gain on the note that Rolland contributed.[73] Under section 704(c)(1)(A), Rolland will be allocated all that gain.[74]

B. Basis Step-Up and Amortization by OpCo

As noted earlier,[75] one of the benefits of this structure is that OpCo receives an FMV basis in the assets of Target. This basis will give rise to depreciation and amortization. Depending on the parties' preferences, the timing of payments on Rolland's note could be set to match those deductions.

[72] Prop. reg. section 1.453B-1(c). Preamble to REG-109187-11, 79 F.R. 76928 (Dec. 23, 2014). *See generally* Jackel, "The Proposed Installment Sale Disposition Regulations," *Tax Notes*, Feb. 2, 2015, p. 641. In the preamble to the proposed regulations, the IRS and Treasury explained that the intent of the proposed regulations was simply to "republish in section 1.453B-1(c) the general rule in section 1.453-9(c)(2) under which gain or loss is not recognized upon certain dispositions." The preamble notes that "section 453B replaces and provides generally the same rules as former section 453(d)."

[73] The amount of gain is determined by reference to Rolland's basis in his stock rather than by the S corporation's basis in its assets. Sections 453B(b) and 722. As a result, if there is a difference between inside and outside basis, the inside basis becomes irrelevant. The character of the gain is also determined by reference to the character of Rolland's stock (*i.e.*, generally capital, consistent with the IRS's position that ordinary income property generally cannot be sold on the installment method). Reg. section 1.453-11 (shareholder in a section 453B(h) transaction generally treated as selling stock).

[74] *See generally* reg. section 1.704-3; and Eric Sloan, Katie Fuehrmeyer, and Jennifer Ray, "Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts (Portfolio 712)" (4th ed.).

[75] *See* the discussion of step 2 in the introduction.

C. Interest on the Note

OpCo will claim interest deductions on the note, subject to the various limitations on the deductibility of interest expense, including section 163(j).[76] Because OpCo is disregarded as a separate entity from Portfolio Co., the payments made by OpCo are treated as being made by Portfolio Co.

D. Section 453A

If the note exceeds the section 453A threshold,[77] Rolland will be required to pay interest on the deferred tax liability under section 453A.[78] Although this certainly would make the structure less attractive to Rolland, it is a cost that is necessary to allow Portfolio Co., Selena, and Rolland to get what they want out of the deal — a basis step-up, a full cash-out, and a tax-deferred rollover, respectively.[79] Moreover, the requirement that interest be paid is an important piece of the carefully crafted statutory regime that Congress created that permits the type of deferral resulting from this structure without unduly benefiting taxpayers or burdening the fisc.

E. Exit

Finally, an adviser would want to consider the fate of the note on exit. If Rolland were to sell his interest in Platform Aggregator, the parties might want the note to accelerate. If the note were to remain outstanding, the buyer of Rolland's interest ought to receive a section 743(b) adjustment that would offset any remaining gain.[80] Similarly, OpCo most likely would want the ability to accelerate payments on the note if there were ever a sale of OpCo (or Portfolio Co.). If Rolland is well-advised, the transaction agreements should include a provision prohibiting acceleration of the note in most other circumstances.

F. An Example

Before the transaction, Target's assets had a basis of $20 million and an FMV of $70 million. All the assets are section 197 intangibles. The $70 million sales price is divided between a $21 million 15-year note for Rolland and a $49 million short-term note for Selena (because Rolland and Selena own 30 percent and 70 percent of New S Corp, respectively).

When New S Corp receives the notes, it recognizes $50 million of gain but takes none of that gain into account under section 453(a) (subject to the various exceptions discussed above). Under section 453B(b), the basis of the Rolland note is $6 million, and the basis of the Selena note is $14 million.

Before the transaction, the value of Platform Aggregator is $77 million. Because of the relative values, when Rolland contributes his $21 million note to Platform Aggregator, he receives a 21.43 percent interest in Platform Aggregator ($21 million divided by Platform Aggregator's post-contribution value of $98 million).

Each year for the next 15 years, OpCo will pay $1.4 million of principal to Platform Aggregator ($21 million divided by 15). Thus, Platform Aggregator takes into account $1 million of gain (the $1.4 million of proceeds minus the $400,000 of basis recovered each year under the gross profit ratio rule in section 453(c) and reg. section 15a.453-1(b)) and allocates all that gain to Rolland under section 704(c)(1)(A). (For simplicity, this example does not address the interest due under the note.)

Further, Portfolio Co. amortizes Target's assets. Because all those assets are amortizable section 197 intangibles, Portfolio Co. amortizes

[76] Reg. section 1.163(j)-6 (especially reg. section 1.163(j)-6(n), which deals with self-charged interest).

[77] Section 453A generally requires interest to be paid on the deferred tax liability resulting from an installment obligation if the sale price and the face amount of installment obligations is sufficiently high and certain other conditions are met. When the payee is a partnership, section 453A interest payments are calculated at the owner (or partner) level. Notice 88-81, 1988-2 C.B. 397.

[78] Although irrelevant to the structure discussed in this report, many M&A transactions involve an element of contingent consideration (such as an earnout, holdback, or even a simple purchase price adjustment) that can cause an installment obligation to be considered contingent. The application of section 453A to contingent obligations is somewhat unclear. For a helpful discussion of some potential approaches, see American Bar Association Section of Taxation, "Comments Regarding Regulations to Be Promulgated Under Section 453A" (May 3, 1991).

[79] In this regard, depending on the deal dynamics, one could imagine the parties negotiating an arrangement that would result in Portfolio Co. and/or Selena bearing some of this cost.

[80] Reg. sections 1.743-1 and 1.755-1.

them ratably over the 15-year period beginning with the month in which Target was acquired.[81] As a result, there is $4.67 million of amortization per year. All $4.67 million of amortization is allocated to Platform Aggregator because, for ease of illustration, the other partners in Portfolio Co. are profits interest holders with $0 capital account balances (and Portfolio Co. incurs a section 704(b) loss in each year). Rolland, as a 21.43 percent partner, is allocated $1 million of depreciation and amortization per year ($4.67 million multiplied by his 21.43 percent interest).

III. One Final Note

As may be obvious, the requirement that the contribution not result in satisfaction of the long-term note means that this disproportionate rollover structure works only if there are different regarded entities that form part of the buyer's structure — one that is the obligor on the note and another to which the note receivable is contributed. That is, Rolland could not contribute the note to Portfolio Co. because doing so would result in satisfaction of the note, making the contribution a taxable disposition of the note under section 453B(a). In the structure described in this report, this is possible because of the tiered partnership structure that many private equity firms use to hold investments. If one were setting up the tiered acquisition structure to facilitate a disproportionate rollover, one would want to consider the application of various judicial, statutory, and regulatory "soft doctrines" and antiabuse provisions, as well as the possibility that the transaction could be recast or re-sequenced. These rules would include: (1) section 7701(o) (providing that tax benefits under subtitle A of the code for a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose); (2) the step transaction doctrine (permitting a series of sufficiently interrelated steps undertaken under a single plan in certain circumstances to be treated as a single transaction, with the immediate, transitory steps being ignored and only the ultimate result being considered for tax purposes); and (3) reg. section 1.701-2 (purportedly authorizing the IRS to recast a partnership transaction if the transaction is "abusive" and treat a partnership as an aggregate of its partners for purposes of applying one or more particular code sections if it is determined that a partnership is more properly treated as an aggregate of its partners rather than as a separate entity for purposes of such section or sections).[82] It is difficult to see how any of section 7701(o), the step transaction doctrine, or reg. section 1.701-2 could be relevant to a transaction like the one described in this report.[83]

Given the meaningful economic impact of the transaction, the relationship among the parties in a typical M&A transaction, and the carefully crafted statutory regime that permits this type of deferral, it seems likely that an adviser would get comfortable that those doctrines and provisions do not apply. ■

[81] Section 197(a).

[82] The IRS has recently sought to apply the partnership antiabuse rule in reg. section 1.701-2 in *Otay*. *See* Motion for Summary Judgment, *Otay Project LP v. Commissioner*, No. 6819-20 (T.C. Nov. 20, 2020). As the taxpayer's counsel in *Otay* points out, however, the government's interpretation of the antiabuse rule, if correct, would likely make the regulation invalid because it would exceed the authority delegated to Treasury by Congress.

[83] There are a handful of older cases in which taxpayers tried to use almost comically frail transactions involving the installment method to escape taxation. Although those cases are worth reading and considering, they ought not be of concern to an adviser structuring a real commercial transaction. *See*, *e.g.*, *Wilkinson v. Commissioner*, 49 T.C. 4 (1967).