When Is a Sale a Sale?

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This topic may sound simple-minded. After all, it is usually easy to tell when a sale (or exchange in the language of the tax law) has occurred. However, a recent interesting (albeit lengthy) field attorney advice, FAA20080101F (Dec. 3, 2007), reminds us that some transactions that are structured as sales may not be.

Facts

FAA20080101F involved a complex fact pattern entailing a transaction occurring over a 10-year period. It's hard to do the Byzantine facts justice, so I'll focus here on only the barest essentials. Three owners of an S corporation ("Owners 1, 2 and 3") sold a percentage of their respective stock in the S corporation to a third party. A Code Sec. 338(h)(10) election was made on the stock sale. The S corporation was in bankruptcy, and there were various suspended lawsuits among and among the third-party purchaser, Owners 1, 2 and 3 and others.

Owners 1, 2 and 3 reacquired the assets (plus others) in a bankruptcy liquidation auction. Owners 1, 2 and 3 then contributed the auction acquired assets to a newly formed S corporation, "NewCo." These assets consisted of inventory, some contracts and a *de minimis* tangible personal property. These assets were used in NewCo's business and then sold to a new nonprofit entity. It was this last purported "sale" to the new nonprofit entity that was subject to scrutiny.

The sale was documented as a contingent payment asset sale with a nonprofit, and the nonprofit executed a nonrecourse contingent payment term note. This term note was set to terminate in a term certain. There was also a nonrecourse contingent payment working capital note. The new nonprofit had no assets prior to making this purchase.

The asset purchase agreement and the other documents listed the following terms for the new nonprofit:

- The nonprofit is required to maintain confidentiality and to pay annual salaries to Owners 1, 2 and 3 during the life of the term note.
- Either Owner 2 or Owner 3 is required to run the business.
- The nonprofit is required to hire NewCo's employees and operate the day to day business.
- The nonprofit is required to enter into a security agreement covering all of its assets.
- The nonprofit is required to pay "profit" to Owners 1, 2 and 3 as term note payments, less a certain share.
- The nonprofit is required to syndicate the nonrecourse contingent payment term note.
- The nonprofit is required to enter into another nonrecourse contingent payment note with NewCo for working capital to run the business.
- The nonprofit is prohibited from entering into any other business.
- The nonprofit is prohibited from selling the assets.

After the first year, the working capital note terminated, and after the stated term of years, the term note terminated as well. It was not clear who would retain the "sold" assets thereafter.

Apart from these basics, the facts thereafter go on for many pages and are enormously complex. However, the real fireworks start in year 10 when the transaction is undertaken by NewCo selling some of the assets it had originally acquired. In the ruling, the IRS indicates that NewCo argues that the year 10 transaction is a contingent payment sale of assets, and that it can use the installment method of accounting. NewCo also argued that in this asset sale, all sale proceeds in excess of its basis in the assets represent payment for goodwill and going concern value.

Cutting through this somewhat Byzantine recitation of the facts, what is interesting in this ruling is that the IRS plainly states that the year 10 transaction is in *form* a sale of assets, but in *substance* something entirely different. Indeed, the IRS notes that NewCo did not relinquish dominion and control over the assets. NewCo continued to run its business using its retained rights in the assets.

Relying on *C.T. Franklin Est.*, 64 TC 752, Dec. 33,359 (1975), *aff'd*, CA-9, 76-2 USTC ¶9773, 544 F2d 1045 (1976), the IRS found no evidence that the transaction was undertaken at fair market value. There was a bankruptcy, and the assets purportedly sold had been purchased for a far smaller figure in an arm's-length open-bid, hotly contested auction some months earlier. Those facts made the IRS feel there was compelling evidence that the assets were worth only a fraction of what NewCo said they were worth.

Interestingly, the IRS even got a chance to mention economic substance, noting that this venerated doctrine disregards transactions and does so here because there was simply no "sale." Substance over form was mentioned as well. Here, in substance, NewCo retained ownership of the assets. Under the various agreements, the purportedly new owner had no right to run the business and, rather, was subject to the condition that one of the owners of NewCo must be the CEO of the new entity, and that NewCo employees must also be hired.

The IRS tries to cover its bases with alternative arguments. As noted by the IRS, NewCo either retained its ownership in the assets, or NewCo and its principals might perhaps hold what is in substance equity interests, which themselves would preclude installment reporting.

In addition to ruling that NewCo was not eligible for installment sale reporting, the IRS concludes that neither the nonrecourse contingent payment term note, nor the nonrecourse contingent payment working capital note, were in fact contingent payment debt instruments at all. Interestingly, the absence of personal liability in the maker of the note(s) did not itself cause the note to fail to be *bona fide*. However, relying on *Franklin*, the IRS noted that the debt did not have economic significance.

After all, the debt could have economic significance only if the business generated substantial profits. The *Franklin* court had stated that with nonrecourse debt, it must be "presently reasonable from an economic point of view" for the taxpayer to make the capital investment. [*See Franklin*, 544 F2d, at 1049.]

Conclusion

Few M&A Tax Report readers may choose to wade through the voluminous and highly confusing epistle that constitutes FAA20080101F. Plus, more than a few readers puzzle over the "FAA" titles, standing for Field Attorney Advice. (The IRS has gotten creative with its nomenclature.) However, the most salient point in this ruling simply seems to be that economic substance can surface in funny ways.

Where there is no true transfer of a bundle of rights, and where nonrecourse notes are used to shift the economics, considerable caution is appropriate. Be careful out there!

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