

Private Letter Ruling 8931025, IRC Sec(s). 453

May 4, 1989

This is in reply to your letter dated January 13, 1989, in which you requested on behalf of A and Corp X rulings under section 453 of the Internal Revenue Code.

Supplemental letters, dated March 22, 1989, March 30, 1989, and April 14, 1989, provided additional facts and representations.

You have represented that A may sell certain real and personal property constituting, in the aggregate, the operating assets of a nursing home and adjacent real estate. Assuming the sale is consummated, it will occur during 1989 to Corp Y at a gain to A. The sale will be under one of several different sets of terms, at A's option. However, you are requesting a ruling only with respect to one particular set of possible terms.

The selling price will be \$ 5,750,000, consisting of three components. The first component will be a cash deposit of \$ 250,000 to be paid upon the execution of the agreement of sale. The second component will be the private placement by Corp Y with A of a bond or bonds issued by State Z Authority in the amount of \$ 4,200,000. {Hereinafter the use of the plural is not to be construed to mean that more than one bond will, in fact, be issued.} In exchange for the issuance of the bonds, Corp Y will give its promissory note (face amount of \$ 4,200,000) to State Z Authority. State Z Authority will transfer its rights to a trustee for the benefit of the bond holder. The trustee will receive payments on the note from Corp Y and service therefrom the bond debt. Corp X will guarantee those debt service payments. The third component will be cash of \$ 1,300,000 to be paid at closing.

You state that A is an individual taxpayer, unrelated to either Corp X or Y. You represent that A holds the property for the production of rental income and is not a dealer within the meaning of section 453(b)(2) of the Code.

You represent that Corps X and Y are related corporations, both qualifying as tax exempt under section 501(c)(3). Although Corp X will negotiate the purchase of the nursing home, prior to actual closing it will assign its rights to purchase the property to Corp. Y, which will then acquire the property.

You represent that the bonds will constitute qualified section 501(c)(3) private activity bonds. The bonds will have a 15-year payment term with level semiannual payments at an interest rate of 9 1/8% per year. The bonds will be secured by the assignment by State Z Authority of its rights in Corp Y's promissory note, a first mortgage on the real estate, and a first position security interest in the other assets. The promissory note will have a 15-year term, a level monthly debt payment schedule and an interest rate of 9 1/8% per year. Corp Y will make the payments on the note to the trustee of the escrow fund established by State Z Authority. The trustee will make payments on the bond to the bond holder. The difference in the bond and note payment schedules will generate funds to be used to pay annual trustee and State Z Authority fees. In no case will surplus earnings accrue to the benefit of A.

You state that neither the full faith and credit nor the taxing power of State Z (or any political subdivision thereof) is pledged to the payment of principal or interest on the bonds. Any such bonds will contain a provision precluding prepayment for 10 years from the date of closing. The sole source of the bond debt service payments will be payments from Corp Y on its note and earnings thereon.

You state that the bond will contain a number of restrictions. The bonds will conspicuously state that any disposition, transfer or assignment of the bonds will be prohibited for a period of one year. Subdivision of the bonds will be prohibited. The bonds will conspicuously state that they are for investment purposes only and that they are "not registered" nor "to be registered" on any securities exchange.

Based on the above representations and facts, you have requested that we rule: (1) that the bonds are not to be treated as readily tradable in an established securities market; and (2) that the sale will qualify as an installment sale under section 453 of the Internal Revenue Code.

Section 453(b)(1) of the Internal Revenue Code defines an installment sale to mean a disposition of property, in which at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453(f)(3) generally carves out from the meaning of the term "payment," receipt of evidences of indebtedness of the purchaser of the property. However, any such indebtedness which is payable on demand or is readily tradable (if issued by a corporation or governmental entity) is brought back within the meaning of the term "payment" by section 453(f)(4) of the Code. Section 453(f)(5) defines the term readily tradable by reference to whether the obligation: (1) has interest coupons attached; (2) is in registered form (unless the obligation, though registered, is not readily tradable in an established securities market); or (3) is in any other form designed to make the obligation readily tradable in an established securities market.

Section 15A.453-1(e)(4)(i) of the temporary regulations states that an obligation will be treated as designed to be readily tradable in an established securities market if, at the time of issuance (or later, if an agreement or understanding existed at the time of issuance), steps necessary to create a market for such obligation are taken.

Under section 15A.453-1(e)(4)(ii) of the temporary regulations an obligation is treated as readily tradable in an established securities market if it is part of an issue or series of issues which are tradable in an established securities market, or the corporation issuing the obligation has other obligations of a comparable character, based on an examination of all relevant factors, including substantial similarity with respect to the presence and nature of security, the number of holders, the principal amount of the obligation, and the number of obligations issued.

Under section 15A.453-1(e)(4)(iii) of the temporary regulations, an obligation is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation, or is part of an issue a portion of which is traded in an established securities market.

Committee reports accompanying the Tax Reform Act of 1969, in connection with changes in the law relating to the issue of whether an obligation is readily tradable, indicate that "ordinary promissory notes are {not} to be included . . . as payments .

. . . even though it is possible for these notes to be assigned by one party to another party {at the time of issuance} .” S. Rep. No. 552, 91st Cong., 1969-3 C.B. 516. However, that legislative history also indicates that the determination of whether an obligation is readily tradable in an established securities market is to be made “in the case of bonds or debentures issued either by a corporation or by a government or political subdivision thereof and is to be applicable regardless of the type of transaction in which the bonds or debentures are received.” Id.

In the present case, the bonds will be issued by State Z Authority, not the purchaser, Corp Y. However, in all other respects, the bond obligations will be that of Corp Y. Corp Y’s note will have the same terms, in all material respects, as the bond. Corp Y’s payments on its note (and earnings thereon) will be the sole funding source for debt service on the bonds. State Z Authority will have no obligation to provide other funds to satisfy the bond obligations.

For purposes of section 453(f) of the Code, it must be established that placement of the bonds with A is the receipt of evidences of indebtedness of the person acquiring the property. In determining whether Corp Y’s note to State Z Authority is, in substance, the same obligation as the bonds placed with A, it is not enough for the two separate obligations to be the same or treated the same in all material respects (amount, term, payment schedule, interest rate, security, etc.). As previously indicated, the committee reports accompanying the 1969 statutory changes stated that the note of an acquiring person is not to be treated as payment even if the note is readily assignable at the time of issuance. Thus, if Corp Y issued a note to A in return for the property in question, the note would generally not constitute payment and such determination would be without regard to the requirements of section 453(f)(4) or (5).

In order for the bonds in this case to be treated as Corp Y’s obligation for purposes of section 453(f)(3), it is therefore necessary for such bonds to be prohibited from transfer at the time of issuance. By virtue of the one-year transfer prohibition (that will be conspicuously stated), the bonds will be nontransferable at the time of issuance.

As a result of the close similarity between the bonds and Corp Y’s note, the bonds will be treated as the obligation of Corp Y, the person acquiring the property, for purposes of section 453(f)(3) of the Code.

Likewise, because of the transfer prohibition and other restrictions on the bonds, the bonds will not be considered as designed to be readily tradable in an established securities market at the time of issuance. Furthermore, since the obligations will not be regularly quoted by brokers or market makers, nor will the obligations be part of an issue a portion of which is so traded, the bonds will not be considered readily tradable in an established securities market. Accordingly, A’s receipt of the bonds will be treated as the receipt of the indebtedness of the person (Corp Y) acquiring the property for purposes of section 453(f)(3) and will not constitute payment for purposes of section 453(b)(1) of the Code.

Having determined that the bonds constitute indebtedness of the purchaser Corp Y in the hands of A and that the bonds do not constitute payment, it follows that the transaction is a sale of property in which at least one payment will be received after

the close of the year of sale. It is therefore an installment sale within the meaning of section 453(b)(1) of the Code.

Based on the facts submitted, the representations made, and the applicable law, we rule as follows:

(1) The bonds issued by the Authority are to be treated as indebtedness of the person acquiring the property (Corp Y) for purposes of section 453(f)(3) and are not to be considered readily tradable in an established securities market for purposes of sections 453(f)(4) and (5) of the Code; therefore the receipt of the bonds by A will not constitute payment for purposes of section 453(b)(1) of the Code.

(2) A's sale will qualify as an installment sale under section 453(b)(1) of the Code.

No opinions are expressed as to the tax treatment of the transaction under the provisions of any other sections of the Code and regulations which may be applicable, or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction which are not specifically covered by the above ruling. For example, no ruling was requested and no ruling has been issued with respect to: (1) the portion of the income from the installment sale which will be eligible for the application of the installment method under section 453(c) of the Code or the portion of such income subject to section 453(i) (relating to recognition of recapture income in the year of disposition); (2) the qualification of the bonds under sections 145 and 141 (or the bond interest under section 103(a)); or (3) the applicability of sections 483 and/or 1272 et seq. of the Code.

A copy of this letter should be attached to the federal income tax return of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

This letter ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.