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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

9  
10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **MARLENE D. CANTER** ) Case No. 421269  
13 )  
14 )

| <u>Years</u> | <u>Proposed Assessments</u> |
|--------------|-----------------------------|
| 1998         | \$257,848                   |
| 1999         | \$124,202                   |
| 2000         | \$ 80,615                   |

18 Representing the Parties:

|                             |   |
|-----------------------------|---|
| 19 For Appellant:           | Christopher Whitney<br>Peter J.H. Kim<br>PriceWaterhouseCoopers LLP |
| 21                          | Barry G. Edwards<br>Hamburg, Karic, Edwards & Martin, LLP           |
| 22 For Franchise Tax Board: | Daniel V. Biedler, Tax Counsel III                                  |

24 QUESTIONS: (1) Whether appellant has shown that respondent erred in using the maximum stated  
25 amount payable under appellant's 1998 installment sale of her business in  
26 calculating the interest due under Internal Revenue Code (IRC) section 453A.

27 (2) For purposes of calculating the interest under IRC section 453A, whether  
28 appellant has shown that respondent erred by not reducing the gain from the sale

1 by payments made by appellant to appellant's former spouse and former  
2 employees.

3 HEARING SUMMARY

4 Background

5 The transaction giving rise to this appeal is the sale of all the stock in Canter Educational  
6 Productions (CEP) and Canter & Associates (C&A), collectively known as the Companies to Sylvan  
7 Learning Systems, Inc. (Sylvan) through a Stock Purchase Agreement dated January 1, 1998. (App.  
8 Opening Br., p.3.) Appellant and her former spouse, Lee Canter (Lee), were the shareholders of the  
9 Companies and in a redemption agreement dated January 1, 1997 (Redemption Agreement), Lee and the  
10 Companies agreed to a redemption of all of Lee's shares<sup>1</sup>. The redemption was expressly conditioned  
11 upon the consummation of a Stock Purchase Agreement by and among Sylvan, the Companies,  
12 appellant and Lee. In exchange for the redemption, the Companies, either directly or through appellant,  
13 agreed to pay Lee an amount calculated as follows:

- 14 1. An initial payment of \$4,675,000 from the proceeds of the purchase of all of the Companies'  
15 capital stock by Sylvan pursuant to the terms and conditions of the Stock Purchase Agreement.
- 16 2. Additional payments equal to 10 percent of all amounts paid by Sylvan pursuant to the Stock  
17 Purchase Agreement, if any, as "Earn-Out Consideration".

18 Lee agreed to deliver the original certificates evidencing ownership of the shares upon delivery of the  
19 executed Redemption Agreement. The Redemption Agreement also recited that Lee, appellant and the  
20 Companies were entering into a consulting agreement concurrent with the Redemption Agreement.  
21 (App. Opening Br., exhibit 3.)

22 Toby Bernstein, Kathy Winberry, and Rob Fiance were executive officers of the  
23 Companies (Executive Officers), who each entered into an employment agreement with the Companies  
24 in 1993 that provided, in relevant part, that the Executive Officer was entitled to an "Asset Sale Bonus"  
25 if appellant or Lee sold any or all of their capital stock in the Companies or if substantially all of the  
26 assets of the Companies or any divisions were sold. (App. Opening Br., exhibit 4, p. 3.) Appellant  
27

28 <sup>1</sup> The redemption agreement recites that Lee owned 25,000 shares of CEP capital stock and 25,000 shares of C&A capital stock.

1 states in her opening brief that, in the event of a sale of the assets or stock of the Companies, Bernstein  
2 would be entitled to 30 percent, Winberry would be entitled to 15 percent and Fiance would be entitled  
3 to 10 percent of the net sales proceeds<sup>2</sup> from the sale of the Companies. (App. Opening Br., pp. 3-4.)  
4 Subsequent to the execution of the Stock Purchase Agreement, appellant and each executive officer  
5 executed a “cancellation/continuing obligation agreement and mutual release of claims” which recited  
6 that it superseded each executive officer’s employment agreement with the Companies and preserved  
7 appellant’s obligations under that employment agreement. (App. Opening Br., exhibit 5.)

8           The Stock Purchase Agreement dated January 1, 1998, was executed “by and among”  
9 Sylvan and appellant, and “joined in by Mr. Lee Canter” whereby Sylvan agreed to acquire all of the  
10 outstanding stock of the Companies from appellant. The Agreement recites that Sylvan, appellant, and  
11 Lee “wish to enter into a definitive agreement setting forth the terms and conditions of the Stock  
12 Purchases.” In the preamble to the agreement, appellant is identified as the sole stockholder of the  
13 Companies and the owner of all the issued and outstanding capital stock in the Companies. (App.  
14 Opening Br., exhibit 2, p.1.) Paragraph 3.4 of the Agreement provides that Lee has “no interest, option  
15 or other rights with respect to the Company Common Stock, any of the assets of either of the Companies  
16 or the Aggregate Purchase Price” other than a consulting agreement with Sylvan and the Redemption  
17 Agreement. (App. Opening Br., exhibit 2, p.15.) The payment of the purchase price of the Company  
18 Common Stock was structured as follows:

- 19       1. An initial purchase price of \$25,000,000 to be paid at closing.
- 20       2. “Additional consideration” computed as \$12.5 million in cash and the number of shares of  
21       Sylvan common stock with a market value of \$12.5 million upon the earlier of the Companies’  
22       achieving (1) EBITDA<sup>3</sup> of \$5 million or more in 1998, (2) cumulative EBITDA of \$15 million  
23       or more during 1998 and 1999 or (3) EBITDA of \$15 million or more during 1998, 1999 and  
24       2000.

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26       <sup>2</sup> The net sales proceeds is defined as “equal to the gross sales proceeds less all costs and expenses directly associated with  
27       such sale and with enforcement and collection actions with respect to such sale.” (App. Opening Br., exhibit 4, p. 4.)

28       <sup>3</sup> Appellant indicates that the Stock Purchase Agreement defines EBITDA to mean the “combined revenues, on a calendar  
basis, of the companies . . . reduced by the companies combined recurring operating expenses . . .” (App. Opening Br.,  
footnote 3.)

1 3. The payment of additional amounts of cash and Sylvan common stock of like value based on the  
2 achievement of specified EBITDA goals. (App. Opening Br., exhibit 2, pp. 17-19.)

3 The Stock Purchase Agreement provides that appellant would use her best efforts to  
4 cause each of the Executive Officers to enter into an employment agreement and non-competition  
5 agreement with one of the Companies. (App. Opening Br., exhibit 2, p.16, paragraph 5.4.) Among the  
6 conditions precedent to Sylvan's fulfillment of its obligations, the Stock Purchase Agreement provides  
7 that the appellant, Bernstein, Winberry, and Fiance shall have executed and delivered an employment  
8 and non-competition agreement. (App. Opening Br., exhibit 2, p.23, paragraph 8.6.) Sylvan also agrees  
9 that appellant and Bernstein would continue as co-chief executive officers of the Companies in  
10 accordance with the employment agreements to be entered into at closing. (App. Opening Br., exhibit 2,  
11 p. 21, paragraph 7.4.)

12 Prior to the full execution of the Stock Purchase Agreement, appellant and Sylvan settled  
13 litigation relating to the operation of the Companies. The settlement agreement set explicit amounts to  
14 be paid to appellant called for under the earn out provisions of the Stock Purchase Agreement.  
15 Appellant received a total of \$73,056,052 before deductions for imputed interest. (Resp. Opening Br.,  
16 p. 2.)

17 Appellant commissioned an appraisal of the fair market value of appellant's interest in  
18 the contingent earn out payments under the Stock Purchase Agreement. (App. Opening Br., p. 4.) The  
19 appraisal report dated April 28, 2006, concluded that as of February 5, 1998, the fair market value of  
20 appellant's interest was equal to \$29,550,330. The report further concludes that after consideration of  
21 appellant's contractual obligations to share the contingent earn out payments with former employees and  
22 her former spouse, appellant's portion is 35% of the total proceeds of those payments equal to  
23 \$10,343,000. (App. Opening Br., exhibit 6, cover letter, p.1.) The Appraisal Report states that "we  
24 understand that these executives were entitled to a total of 55% of the net proceeds from the Contingent  
25 Payments." (Mr. Bernstein was entitled to 30%, Ms. Winberry was entitled to 15%, and Mr. Fiance was  
26 entitled to 10%.)<sup>4</sup> (App. Opening Br., exhibit 6, p.12.)

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<sup>4</sup> Lee Canter was entitled to the remaining 10 percent of the purchase price.

1 **QUESTION (1): Whether appellant has shown that respondent erred in using the maximum**  
2 **stated amount payable under appellant’s 1998 installment sale of her business in calculating the**  
3 **interest due under Internal Revenue Code (IRC) section 453A.**

4 Contentions

5 Appellant’s Contentions

6 Appellant asserts that respondent’s use of a presumed maximum face value of \$50  
7 million as the basis for the IRC section 453A interest charge is incorrect because the Stock Purchase  
8 Agreement had no maximum face value and the IRC section 453A interest charge should not be based  
9 on maximum face value of the contingent note. (App. Opening Br., p. 7.) First, appellant contends that  
10 the Stock Purchase Agreement did not include a maximum amount payable to appellant. Appellant  
11 points to section 7.3(b)(2)(c) of the Stock Purchase Agreement which states that “[i]f in any of these  
12 three years, the Companies exceed the EBITDA amount for that year set forth above, the Purchaser will  
13 pay [appellant] further consideration of one dollar of cash and the number of share of the Purchaser’s  
14 Common Stock having a then Market Value of one dollar for each one dollar of EBITDA in excess of  
15 the EBITDA amount for that year.” Pursuant to the foregoing provision, appellant contends that the  
16 contingent earn out had no stated maximum amount because the potential amount payable was  
17 unlimited. (App. Opening Br., pp. 8-9.) Appellant further contends that respondent incorrectly places  
18 reliance on regulations promulgated to interpret and implement IRC section 453, which relate to  
19 contingent notes with a maximum face value. Appellant asserts that those regulations govern the timing  
20 of the recognition of gain on a contingent note and have no bearing on the determination of the amount  
21 of deferred gain for purposes of IRC section 453A. (App. Opening Br., p. 9.)

22 More generally, appellant contends that the maximum amount payable under an  
23 installment sale agreement, such as the Stock Purchase Agreement, is not the appropriate starting point  
24 in calculating the IRC section 453A interest charge. By enacting IRC section 453A, appellant asserts  
25 that Congress intended to treat taxpayers who elect installment sale treatment in the same position as  
26 taxpayers who elect out of the installment method. Appellant contends that the use of the maximum  
27 amount payable in calculating the IRC section 453A interest charge is inconsistent with Congress’  
28 intent. Appellant explains that a taxpayer who elects out is required by the regulations under IRC

1 section 453 and IRC section 1001 to report the fair market value of the earn out contingent payments in  
2 computing the gain recognized on the sale. If a greater or lesser amount is received in a later year than  
3 initially projected, the taxpayer would report a capital gain or capital loss in that later year. Appellant  
4 characterizes respondent's use of maximum selling price as a regulation which has not been adopted in  
5 accordance with statutory requirements. Thus, appellant concludes that respondent has no valid legal  
6 authority to support its position. (App. Opening Br., pp. 9-11.)

7 With respect to its own position, appellant contends that in the absence of regulations  
8 from the Internal Revenue Service (IRS) or guidance from respondent, the use of a reasonable method,  
9 such the fair market value of contingent earn out, is appropriate. Appellant notes that the IRS has  
10 consistently stated that when regulations are issued a long period of time after the related statutory  
11 provisions, reasonable methods may be used by a taxpayer to comply with the statutory requirements for  
12 the period between the effective date of the statute and applicable effective date of the regulations.  
13 Appellant notes that certain IRS regulations issued a number of years following enactment of the related  
14 statutory provisions provide that any reasonable method may be used by taxpayers to comply with the  
15 statutory requirement during the period between the effective date of the statute and the applicable date  
16 of the regulation.<sup>5</sup> Moreover, appellant states that California has adopted all such regulations and, in  
17 doing so, approved the IRS's reasonable method standard. (App. Opening Br., pp. 11-12.)

18 Appellant refers to the two alternative methods considered by the IRS – the fair market  
19 value method and the wait-and-see method – and concludes that the fair market value method is  
20 reasonable because it places the taxpayer who elects the installment method on the same footing as the  
21 taxpayer who elects out. Appellant also asserts that the fair market value method is consistent with prior  
22 Board decisions. (App. Opening Br., pp. 14-15.)

23 In reply to respondent's opening brief, appellant asserts that the contingent earn out  
24 payments were highly uncertain and could range from \$0 to an unlimited amount. Appellant contends  
25 that respondent's separation of the earn out provisions into three tiers has no legal basis and essentially  
26 misconstrues the Stock Purchase Agreement as three separate agreements when it fact it constitutes the  
27

28 <sup>5</sup> Appellant cites the relevant regulations related to IRC sections 108(e)(4), 121, 864(b)(2)(A)(ii) & (b)(ii), 1254(b), 1092(b),  
and 263A(i).

1 consummation of a single transaction. (App. Supp. Br., pp. 6-7.) Even though respondent  
2 acknowledges that the “third tier” of the earn out consideration had no stated maximum amount payable,  
3 appellant contends that respondent, nonetheless, reaches the unreasonable and legally unsupportable  
4 conclusion that the total of the first and second tiers, \$50 million, should be used as the maximum  
5 amount payable to appellant for purposes of IRC section 453A. (Resp. Reply. Br., p. 7.)

6 In addition to the arguments set forth above, appellant contends that its position that the  
7 IRC section 453 regulations are not applicable to the determination of the IRC section 453A interest is  
8 supported by the fact that those regulations were promulgated several years before the enactment of IRC  
9 section 453A. Appellant also points out that IRC section 453 considers each installment sale on an  
10 aggregate basis such that the income recognized for each taxable year is that portion of the payments  
11 received in that year which the gross profit bears to the total contract price. Here, appellant asserts, the  
12 total contract price did not have a fixed value and, for that reason, respondent has no legal authority for  
13 segregating the earn out consideration into three artificial tiers. (App. Supp. Br., pp. 8-9.)

#### 14 Respondent’s Contentions

15 Respondent asserts that its determination of appellant’s recognition of gain for purposes  
16 of reporting under the installment method, based on the maximum selling price, is afforded a  
17 presumption of correctness. Respondent states that it used the maximum selling price as required by the  
18 applicable regulation under IRC section 453, Temporary Treasury Regulation section 15.453-  
19 1(c)(2)(i)(A), which prescribes the method for determining the amount of gain that a taxpayer must  
20 recognize each year under the installment method of reporting pursuant to IRC section 453. Respondent  
21 contends that its calculation of the amount of gain realized for purposes of IRC section 453A is  
22 consistent with the statutory scheme under both sections. Respondent contends that, pursuant to  
23 California appellant case law, section 453A must be construed consistently with the installment sales  
24 rules under IRC section 453 and the regulations thereunder. Respondent further contends that there is  
25 no legal authority for appellant’s position that the amount of realized gain reported for purposes of IRC  
26 section 453 may be a different amount than reported for IRC section 453A purposes. In addition,  
27 respondent contends that appellant’s position is inconsistent and illogical with the installment sales  
28 reporting rules, particularly in view of the actual amount paid by Sylvan under the Stock Purchase

1 Agreement. (Resp. Opening Br., p. 4.)

2 Applicable Law

3 California law has generally adopted the provisions under IRC sections 453 and 453A  
4 relating to the installment method and special rules for nondealers. (Rev. & Tax. Code, § 24667(a)(1).)  
5 IRC section 453, subdivision (a) provides generally that “income from an installment sale shall be taken  
6 into account for purposes of this title under the installment method.” As relevant here, an installment  
7 sale is defined, for purposes of the section, as “a disposition of property where at least 1 payment is to be  
8 received after the close of the taxable year in which the disposition occurs.” (Int.Rev. Code  
9 § 453(b)(1).) The installment method is defined, for purposes of the section as “a method under which  
10 the income recognized for any taxable year from a disposition is that proportion of the payments  
11 received in that year which the gross profit (realized or to be realized when payment is completed) bears  
12 to the total contract price.” (Int.Rev. Code § 453(c).) A taxpayer may opt out of reporting an  
13 installment sale under the installment method by making a timely election. (Int.Rev. Code § 453(d).)

14 IRC section 453A provides that “[t]his section shall apply to any obligation which arises  
15 from the disposition of any property under the installment method, but only if the sales price of such  
16 property exceeds \$150,000.” (Int.Rev. Code, § 453A (b)(1).) With respect to an installment obligation  
17 to which section 453A applies “interest shall be paid on the deferred tax liability with respect to such  
18 obligation in the manner provided under subsection (c).” (Int.Rev. Code, § 453A (a)(1).) However, the  
19 interest provision is applicable only if the installment obligation is outstanding as of the close of such  
20 taxable year *and* the face amount of all such obligations held by the taxpayer which arose during, and  
21 are outstanding as of the close of, such taxable year exceeds \$5,000,000. (Int.Rev. Code, § 453A  
22 (b)(2)(A) and (B).) An IRS private letter ruling, TAM 9853002, concluded that by imposing interest on  
23 the applicable percentage of a deferred tax liability, Congress required a taxpayer to forgo the time value  
24 of the money that would have been used to pay the deferred taxes, thereby placing the taxpayer in a  
25 position similar to a taxpayer who elected out of the installment method.

26 The interest for any taxable year is computed by multiplying the applicable percentage of  
27 the deferred tax liability with respect to such obligation by the underpayment rate in effect under IRC  
28 section 6621(a)(2) for the month with or within which the taxable year ends. (Int.Rev. Code, § 453A

1 (c)(2)(A) and (B).) For purposes of IRC section 453A, “deferred tax liability” means, with respect to  
2 any taxable year, “the amount of gain with respect to an obligation which has not been recognized as of  
3 the close of such taxable year, multiplied by the maximum rate of tax in effect under section 1 or 11,  
4 whichever is appropriate, for such taxable year.” (Int. Rev. Code, § 453A(c)(3)(A) and (B).) The  
5 “applicable percentage” of the deferred tax liability is determined by dividing “the portion of the  
6 aggregate face amount of such obligations outstanding as of the close of such taxable year in excess of  
7 \$5,000,000, by the aggregate face amount of such obligations outstanding as of the close of such taxable  
8 year.” (Int. Rev. Code, § 453A (c)(4)(A) and (B).) IRC section 453A also provides that the Secretary of  
9 the Treasury “shall prescribe such regulations as may be necessary to carry out the provisions of this  
10 subsection including regulations providing for the application of this subsection in the case of contingent  
11 payments, short taxable years, and pass-thru entities.” (Int.Rev. Code, § 453A(c)(6).)

#### 12 Valuation of Contingent Installment Obligations

13 Although IRC section 453A(c)(6) provides that regulations shall be prescribed as  
14 necessary to carry out the provisions for contingent payments, no regulation has been promulgated that  
15 prescribes the method for valuing a contingent installment obligation for purposes of computing interest  
16 under IRC section 453A. In addition, the IRS has not provided any other guidance in this area.

17 With respect to regulations promulgated under IRC section 453, Treasury Regulations  
18 section 15a.453-1 generally provides that, unless a taxpayer elects otherwise, income from a sale of real  
19 property or a casual sale of personal property, where any payment is to be received in a taxable year  
20 after the year of sale, is to be reported on the installment method. (26 C.F.R. § 15a.453-1(a) (2008).)  
21 The regulation sets forth rules describing installment method reporting of a “contingent payment sale”  
22 which means “a sale or other disposition of property in which the aggregate selling price cannot be  
23 determined by the close of the taxable year in which such sale or other disposition occurs.” (26 C.F.R.  
24 § 15a.453-1(c)(1) (2008).)

25 Subsection (c)(2)(i)(A) of section 15a.453-1 provides that “a contingent payment sale  
26 will be treated as having a stated maximum selling price if, under the terms of the agreement, the  
27 maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end  
28 of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall

1 be determined by assuming that all of the contingencies contemplated by the agreement are met or  
2 otherwise resolved in a manner that will maximize the selling price and accelerate payments to the  
3 earliest date or dates permitted under the agreement.” The maximum selling price is used to determine  
4 the gross profit ratio from the sale upon which the recovery of the taxpayer’s basis in the property sold is  
5 computed. (26 C.F.R. § 15a.453-1(c)(2)(i)(A) (2008).)

6 If a taxpayer elects out of installment method reporting, Treasury Regulation section  
7 15a.453-1 provides, in relevant part, that the fair market value of a contingent installment payment  
8 obligation “may be ascertained from, and in no event shall be considered to be less than, the fair market  
9 value of the property sold (less the amount of any other consideration received in the sale).” (26 C.F.R.  
10 § 15a.453-1(d)(2)(iii) (2008).) Furthermore, only in “rare and extraordinary cases” when the fair market  
11 value of the obligation cannot be reasonably ascertained will the taxpayer be entitled to assert that the  
12 transaction is “open.” (*Id.*)

#### 13 Presumption of Correctness

14 It is well established that respondent’s determination is presumed to be correct and that  
15 the burden is on the taxpayer to prove that it is erroneous. (*Appeal of Janice Rule*, 76-SBE-099, Oct. 6,  
16 1976.) However, the presumption is a rebuttable one and will only support a finding in the absence of  
17 sufficient evidence to the contrary. (*Appeal of Janice Rule*, *supra.*) Respondent’s determination is not  
18 evidence to be weighed against evidence produced by the taxpayer. (*Appeal of Janice Rule*, *supra.*) The  
19 presumption of correctness disappears once evidence that would support a contrary finding has been  
20 submitted. (*Appeal of Janice Rule*, *supra.*)

#### 21 Staff Comments

22 Here, there is no dispute that IRC sections 453 and 453A applied to the stock sale  
23 transaction and appellant has stated that she did not elect out of reporting the sale in 1998 under the  
24 installment method. As the parties have acknowledged, there is no direct legal authority or guidance  
25 prescribing a method for establishing a value for a contingent installment payment obligation for  
26 purposes of computing interest under IRC section 453A where, as in this case, the agreement does not  
27 state a maximum sales price. One scholarly commentary has concluded that the calculation of a  
28 taxpayer’s IRC section 453A interest liability on a particular installment obligation requires a

1 determination of the amount of unrecognized income attributable to that obligation at the close of the  
2 taxable year. (Kaden & LaFrance, *A Review of Recent Decisions of the United States Court of Appeals*  
3 *for the Federal Circuit: Article: Installment Method Asset Sales by S Corporations* (1990) 39 Am.  
4 U.L.R. 915.) The commentary discusses two possible approaches which, in fact, are the treatments  
5 proposed by the parties. The first approach discussed, as appellant has argued, is to treat the amount of  
6 unrecognized gain as the gain which the taxpayer would have recognized on the note had the reporting  
7 entity elected out of installment reporting. Under this election-out approach, the amount of deferred tax  
8 and hence the amount of the section 453A interest charge would be tied to the fair market value of the  
9 obligation on the date the asset sale takes place. The face amount of the obligation, for purposes of  
10 computing the applicable percentage, could be determined in the same manner. (*Id.* at 945.)

11           The second approach for quantifying the unrecognized income arising from a contingent  
12 note, which respondent has taken, parallels the method currently prescribed in the income tax  
13 regulations for calculating a seller's gross profit ratio on receipt of contingent installment payments.  
14 Under this approach, the applicable percentage and amount of unrecognized income is based on the  
15 maximum amount payable, if any, on the contingent note. The commentary concludes by stating that, in  
16 the "rare and extraordinary" case in which a taxpayer receives a contingent obligation that is not  
17 susceptible of valuation under either approach, the taxpayer should not incur a section 453A interest  
18 charge. (*Id.* at 946-947.)

19           Thus it appears that the calculation of an IRC section 453A interest liability requires a  
20 determination of the unrecognized income on a contingent installment obligation at the close of the  
21 taxable year of the transaction. However, the proper approach to be used will depend upon the  
22 reliability of the information available in a particular case as of the close of the taxable year.

23           Respondent should be prepared explain how a maximum face value of the contingent  
24 installment obligation can be determined in view of the fact that the earn out provisions seem to allow  
25 for the payment of indeterminate amounts based on the level of EBITDA in the applicable years.  
26 Respondent should also discuss whether it disputes any of the assumptions or the fair market value  
27 determination of appellant's appraisal.

28 ///

1 **Question (2): For purposes of calculating the interest under IRC section 453A, whether appellant**  
2 **has shown that respondent erred by not reducing the gain from the sale of appellant's stock by**  
3 **payments made by appellant to appellant's former spouse and former employees.**

4 Contentions

5 Appellant's Contentions

6 Payments to Lee Canter

7 In its reply brief, appellant states that the payments to Lee Canter are no longer in issue  
8 because respondent, at audit and at protest, already determined that those payments should be allowed as  
9 a deduction in calculating the amount of interest under IRC section 453A. (App. Supp. Br., pp. 11-12.)  
10 Respondent allowed an increase in appellant's basis in her shares of the Companies' stock by the  
11 \$4,675,000 appellant paid to Lee in 1998, but did not allow an increase in basis in later years until those  
12 amounts from the sales proceeds of the Companies' stock were actually paid. (Resp. Reply. Br., p. 2.)  
13 In the supplemental brief, appellant disputes respondent's position that appellant is seeking "an  
14 unwarranted" benefit for the payments to Lee as a deductible selling expense in addition to the increase  
15 in stock basis already allowed by respondent. Appellant states that respondent is "factually incorrect" in  
16 that characterization because appellant has accepted respondent's treatment with the result that appellant  
17 is not being assessed income tax or an IRC section 453A interest charge on the amounts that she was  
18 contractually obligated to pay Lee. (App. Reply. Br., p. 3.) Appellant asserts that she is not asking for  
19 any additional benefit or deduction for these payments to Lee as a "cost of sale." (App. Reply. Br.,  
20 p. 9.)

21 Appellant also contends that respondent has confused the facts of the sale transaction and  
22 that respondent has obfuscated the inconsistent approach that respondent has taken with respect to her  
23 contractual obligations to Lee and the Executive Officers. Appellant contends that respondent's  
24 assertion that Lee was the owner of his stock until he received all of the payments called for in the  
25 redemption agreement is "plainly wrong and contrary to the evidence" provided by appellant. In support  
26 of her argument, appellant points to the language in the Stock Purchase Agreement and the Redemption  
27 Agreement as evidence that Lee's entire interest in the Companies was redeemed. (App. Reply. Br.,  
28 p. 4.) Appellant contends that the fact that Lee was entitled to 10 percent of the net sale proceeds does

1 not affect the redemption of his entire interest which left appellant as the sole shareholder. (App. Reply.  
2 Br., p.5.)

### 3 Payments to the Executive Officers

4 Appellant contends that respondent has incorrectly concluded that appellant may not  
5 deduct the payments to the Executive Officers because those payments did not arise from the Stock  
6 Purchase Agreement. Appellant maintains that as a condition of terminating their employment  
7 agreements, the Executive Officers required that appellant personally assume the payment obligation.  
8 Appellant also states that she never would have been obligated to make the payments absent the Stock  
9 Purchase Agreement. In addition, appellant asserts that the agreements between appellant and the  
10 Executive Officers were negotiated and agreed upon in anticipation of the stock sale. For all those  
11 reasons, appellant contends that her obligation to make the payments arose from the Stock Purchase  
12 Agreement. (App. Reply Br., p. 12.)

13 Appellant further argues that Sylvan would have reduced its purchase price if appellant  
14 had not assumed the payment obligation. In that event, appellant concludes, the economic effect of the  
15 transaction would have been the same such that appellant would not have been liable for an IRC section  
16 453A interest charge on payments made directly by Sylvan to the Executive Officers. Because she was  
17 only entitled to 35 percent of the purchase price, appellant contends that it is inequitable for respondent  
18 to impose the IRC section 453A interest on the 55 percent of the purchase price that appellant was  
19 obligated to pay the Executive Officers. (App. Reply Br., p. 13.)

20 In her reply brief, appellant argues that Sylvan insisted that (1) the existing employment  
21 contracts be cancelled and that (2) the Executive Officers should remain in their positions after the  
22 purchase and enter into new employment agreements with Sylvan. As a result of those conditions,  
23 appellant contends, her assumption of the obligation and the obligation itself directly arose from the sale  
24 of the companies contrary to respondent's assertion otherwise. (App. Reply. Br., pp. 5-6.) Appellant  
25 also contends that respondent has treated the payments to Lee and the Executive Officers inconsistently  
26 because respondent reduced appellant's gain and the IRC section 453A interest for the payments to Lee  
27 but not for the payments to the Executive Officers. (App. Reply. Br., p. 6.)

28 Appellant disputes respondent's contention that appellant is seeking a "double benefit"

1 by requesting a reduction of the IRC section 453A interest charge for the payments made to the  
2 Executive Officers. Appellant contends that the deduction of the payments from her gain on the sale  
3 does not preclude consideration of these payments to determine her fair market value of the contingent  
4 installment obligation. Appellant believes that the deduction of those payments to calculate her gain on  
5 the sale for the determination of the income tax requires that the fair market value of those payments be  
6 deducted for the purpose of calculating the IRC section 453A interest charge. (App. Reply. Br., p. 10.)

7 Respondent's Contentions

8 Payments to Lee Canter

9 Respondent contends that appellant's obligation to make payments to Lee under the  
10 redemption agreement arose from the dissolution of their marriage rather than from the sale of the  
11 Companies' stock. Respondent asserts that appellant and Lee agreed upon a property division as part of  
12 the marital dissolution that called for the redemption of Lee's stock in the Companies. Because the  
13 redemption agreement arose from the marital dissolution as an independent transaction, respondent  
14 contends that those payments should not reduce the amount of gain upon which the IRC section 453A  
15 interest is based. In addition, respondent asserts that the payments served a purpose other than the  
16 process of disposing of the Companies and that the price that Sylvan was willing to pay was not affected  
17 by appellant's obligation to Lee or the Executive Officers. (Resp. Opening Br., pp. 5-6.)

18 In its reply brief, respondent contends that, contrary to appellant's assertion, the  
19 payments to Lee are still in issue because appellant is contesting respondent's disallowance of any  
20 increase in appellant's stock basis until those payments were actually made. (Resp. Reply. Br., p. 2.)  
21 Respondent also finds appellant's representation that she was the 100 percent owner of the stock at the  
22 time of the sale irreconcilable with her position that she is entitled to deduct the amount paid to Lee as a  
23 cost of sale to redeem Lee's shares. In respondent's view, the fact that the amounts that appellant paid  
24 to redeem Lee's stock "was measured on and paid from funds appellant received from Sylvan indicates  
25 that she was not owner of 100 percent" of the stock. Respondent contends, moreover, that the structure  
26 of the transaction shows that Lee sold his stock directly to Sylvan and that appellant took possession of  
27 Lee's stock or the proceeds payable to Lee only as an agent of Sylvan. Thus, respondent contends that  
28 Lee could be viewed as the owner of his stock until all of the payments in the redemption agreement

1 were made. Respondent states that respondent allowed appellant to increase her basis even though she  
2 could not demonstrate that she owned Lee's stock which thereby reduced appellant's taxable gain.  
3 Respondent contends that allowing appellant to also deduct those amounts as a cost of sale would  
4 provide appellant with an unwarranted additional benefit. (Resp. Reply. Br., p. 3.)

5 Payments to the Executive Officers

6 Respondent states that, at least as far back as 1993, employment contracts with several  
7 key employees of the Companies included bonus payments based on amounts received from a buyer of  
8 the Companies. Respondent further states that all those amounts were consideration for services  
9 performed by the employees. Thus, respondent contends that the Companies and appellant provided  
10 incentives to the Executive Officers by offering equity shares in the Companies and, based on the  
11 record, appellant received full value from that bargain. Respondent contends that although the timing  
12 and source of the funds to pay the bonus compensation was the sale to Sylvan, the payment obligations  
13 arose from the employment contracts and not from the Stock Purchase Agreement. Respondent also  
14 contends that appellant's agreement to modify the employment contracts did not make those payments  
15 an expense incurred in the process of the sale. (Resp. Opening Br., pp. 5-6.)

16 As with the payments to Lee, respondent asserts that the price that Sylvan was willing to  
17 pay was not affected by appellant's obligations to the Executive Officers. Respondent contends that the  
18 payment obligations existed regardless of whether the sale took place and that the modification of the  
19 employment contracts caused the responsibility to remain with appellant rather than shift to Sylvan as  
20 the new owner. If the employment contracts had not been so modified, respondent concludes that  
21 Sylvan presumably would have reduced the purchase price paid. (Resp. Opening Br., pp. 6-7.)

22 In its reply, respondent contends that appellant's characterization of the amounts paid to  
23 Lee and the Executive Officers is erroneous and inconsistent with tax accounting requirements.  
24 Respondent contends that appellant initially failed to report the sale as an installment sale and when she  
25 subsequently reported it as an installment sale appellant failed to reverse the deductions originally  
26 claimed for amounts paid to Lee and the Executive Officers. Respondent contends that, as a cash basis  
27 taxpayer, appellant may not include expenses of the sale as deductions in an installment sale  
28 computation until they are actually paid. Thus, respondent contends that appellant is not entitled to treat

1 the bonus compensation and the payments to Lee as expenses that reduce the selling price until those  
2 amounts are actually paid. (Resp. Reply. Br., pp. 3-4.)

3 Respondent explains that appellant originally erroneously reported the income on her  
4 Schedule D and Form 4797 as payments were received and deducted the payments to Lee and the  
5 Executive Officers as selling expenses on her Schedule E as ordinary deductions. Because appellant  
6 already deducted the payments which reduced her overall tax liability, respondent contends that  
7 appellant now seeks a “double benefit” by characterizing those payments as expenses of the sale of the  
8 stock. (Resp. Reply. Br., p. 4.) Respondent contends that if the Board accepts appellant’s position that  
9 the payments are properly characterized as expenses of the stock sale and thus included as a component  
10 of the installment sale calculation then those expenses should be spread over the term of the installment  
11 sale and reported on the Form 6252 and not as a Schedule E ordinary expense deduction. Respondent  
12 contends that appellant must choose between the two methods of reporting those payments and may not  
13 have the benefit of both treatments. In addition, respondent states that appellant chose to report them as  
14 Schedule E ordinary expenses and respondent is now precluded from disallowing those deductions and  
15 recomputing the tax liability based on the treatment of those payments as expenses of the stock sale.  
16 (Resp. Reply. Br., pp. 5-6.) Respondent further contends that if appellant is allowed to treat the  
17 payments as expenses of the sale, the tax effect should be an overall reduction of tax due of \$58,983  
18 (excluding interest) based on the requirement that employee bonuses allowed to reduce the selling price  
19 must also reduce the “gain recognized in each year”, a component of the IRC section 453A interest  
20 calculation. In this respect, respondent argues that appellant must not be allowed to reduce the gain  
21 recognized on the sale while also reducing her taxable income by deducting the payments from her  
22 taxable income. (Resp. Reply. Br., p. 6.)

### 23 Applicable Law

24 IRC section 1001, subdivision (a) defines gain from the sale or other disposition of  
25 property as the “excess of the amount realized therefrom over the adjusted basis provided in section  
26 1011 for determining gain.” IRC section 1011, subdivision (a) provides that the adjusted basis for  
27 determining gain from the sale of property shall be the basis determining in accordance with applicable  
28 provisions of specified subchapters adjusted as provided in section 1016.” The U.S. Supreme Court has

1 held that “legal, brokerage, accounting, and similar costs” incurred in the acquisition or disposition of an  
2 asset are considered capital expenditures that are as much part of the cost of the asset as the price paid  
3 for it. Such expenditures are added to the basis of the capital asset for which they are incurred, and “are  
4 taken into account for tax purposes either through depreciation or by reducing the capital gain (or  
5 increasing the loss) when the asset is sold.” As a consequence, the Court held that a capital expense  
6 cannot be deducted as “ordinary and necessary”, either as a business expense under IRC section 162<sup>6</sup> or  
7 as an expense of “management, conservation, or maintenance” under IRC section 212. (*Woodward v.*  
8 *Commissioner* (1970) 397 U.S. 572, 575-576.) Thus, any valid expenses incurred by appellant in the  
9 sale of her stock would be considered capital expenditures and a component of the adjusted basis of the  
10 stock.

11 The installment method is generally defined as “the amount of any payment which is  
12 income to the taxpayer is that portion of the installment payment received in that year which the gross  
13 profit realized or to be realized bears to the total contract price (the “gross profit ratio”).” (Temp. Treas.  
14 Reg. § 15a.453-1 (b)(2)(i).) “Gross profit” is defined as the selling price less the adjusted basis as  
15 defined in section 1011 and the regulations thereunder. (Temp. Treas. Reg. § 15a.453-1 (b)(2)(v).)  
16 “Selling price” is defined as the gross selling price without reduction to reflect any existing mortgage or  
17 other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for  
18 installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling  
19 expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a  
20 part of the selling price.” (Temp. Treas. Reg. § 15a.453-1 (b)(2)(ii).) Thus, for purposes of applying the  
21 installment method, any selling expenses are properly a component of the adjusted basis and not an  
22 amount that may be deducted from the selling price.

### 23 Staff Comments

24 It appears to staff that the original compensation agreements were a separate agreement  
25 and that the subsequent continuing obligation agreement was a condition of the stock sale agreement.  
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27 <sup>6</sup> IRC section 162, subdivision (a)(1) provides that “[t]here shall be allowed as a deduction all the ordinary and necessary  
28 expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for  
salaries or other compensation for personal services actually rendered.”

1 Absent the continuing obligation agreement, it appears the stock sale agreement would not have been  
2 consummated. In view of the foregoing discussion of the law, it appears to staff that if the payments to  
3 Lee and the Executive Officers are found to be expenses of the stock sale then they must be treated as  
4 capital expenditures which are an adjustment to appellant's basis in the stock and appellant may not  
5 deduct them as ordinary expenses under IRC section 162 or any other section of the Code. With respect  
6 to the character of the payments to Lee and the Executive Officers, the Appeals Division notes that the  
7 Court in *Woodward* stated that "legal, brokerage, accounting, and similar costs" incurred in the  
8 acquisition or disposition of an asset are considered capital expenditures. In the view of the Appeals  
9 Division, the payments to Lee and the Executive Officers were separate obligations assumed by  
10 appellant which were not similar to legal, brokerage and accounting costs. At the hearing, appellant  
11 should be prepared to present argument and to provide any case law or other legal authority to support  
12 her position that the payments to Lee and the Executive Officers should be considered expenses of the  
13 sale. In addition, if the payments are treated as expenses of the sale, appellant should be prepared to  
14 explain whether she takes the position that she properly deducted them as ordinary expenses and that  
15 they should be allowed to reduce her recognition of gain on the stock sale.

16 Payments to Lee Canter

17 Appellant states that she agrees with respondent's treatment of the payments to Lee as an  
18 adjustment to stock basis to reduce appellant's recognition of gain and the IRC section 453A interest  
19 charge. However, respondent contends the payments to Lee are still in issue because (1) appellant  
20 contests respondent's disallowance of increases in appellant's stock basis until the payments were  
21 actually made and (2) appellant is also seeking to deduct those amounts as a cost of sale. At the hearing,  
22 appellant should be prepared to clarify whether respondent has correctly characterized her position and,  
23 if so, she should provide legal authority to support the position that the payments should be treated as  
24 both basis adjustments and deductible ordinary expenses.

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