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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Tax Year Involved:

Date of Conference:

LEGEND:

Taxpayer:
State A:
Year 1:
Year 2:
Year 3:
$a:
$b:
$c:

ISSUES:

1. Whether Taxpayer's adjusted basis for its funeral home business, for purposes of computing its gain on the sale of the business, includes the net of the following amounts related to certain pre-need funeral contracts included in the sale: (1) the amounts received from the contract customers that Taxpayer treated as continuing to belong to the customers and at the time of the sale as held for the customers in one or more "Trust Accounts," plus (2) the amount of Taxpayer's accounts receivables related to the contracts, less (3) Taxpayer's estimated cost to provide the merchandise and services specified in the contracts.

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2. Whether Taxpayer's amount realized from the sale includes an amount equal to Taxpayer's estimated cost to provide the merchandise and services specified in the contracts because the purchaser of the contracts assumed Taxpayer's obligation to provide the merchandise and services.

CONCLUSIONS:

1. Taxpayer's adjusted basis for its funeral home business does not include the net of the three amounts described above.

2. Taxpayer's amount realized from the sale of its funeral home business does not include Taxpayer's estimated cost to provide the merchandise and services specified in the contracts.

FACTS:

Taxpayer, an S corporation, operated a funeral home in State A from Year 1 until Year 3, when it sold the assets of the business to another corporation ("Purchaser"). In computing its gain from this sale (the "Year 3 Sale") on the Form 4797 (Sales of Business Property) attached to its Form1120S (U.S. Income Tax Return for an S Corporation) for the tax year ending December 31, Year 3, Taxpayer reported that its amount realized from the sale was $a, that its adjusted basis for the business was $b, and that its gain before selling expenses was $c. After examining Taxpayer's Year 3 Form 1120S, the field requested technical advice as to whether Taxpayer reported too little gain with respect to the Year 3 Sale because it failed to properly take into account that part of the Year 3 Sale consisting of the transfer of the pre-need funeral contracts that Taxpayer had entered into during Year 2 through Year 3 (the "Pre-Need Contracts").

A typical Pre-Need Contract required its customer to pay a specified amount to Taxpayer in one or more installments. In exchange, Taxpayer became obligated to provide after the customer's death the funeral merchandise (e.g., caskets, urns, vaults, markers and clothing) and services specified in the contract. During the conference of right, Taxpayer's representatives indicated that the customer could cancel the contract and receive a full refund of the amounts previously paid.

Prior to the death of a Pre-Need Contract customer, Taxpayer generally treated the payments received from the customer (1) as belonging to the customer and (2) as

held in trust by Taxpayer for the customer.[1] Taxpayer deposited these payments in one of three accounts (each a "Trust Account"). At the time of the Year 3 Sale, each Trust Account held only funds received from Pre-Need Contract customers that Taxpayer treated in this manner. Generally, only after a Pre-Need Contract customer died and Taxpayer furnished the funeral merchandise and services specified in that contract did Taxpayer claim ownership of the funds previously received from the customer. At that time, Taxpayer would withdraw from the Trust Accounts the deceased customer's payments (less any amount of such payments that had previously been withdrawn).

At the time of the Year 3 Sale, Taxpayer had accounts receivable for the portions of the contract prices of the Pre-Need Contracts that it had not yet received from its customers (the "Pre-Need Receivables").

Prior to the Year 3 Sale, Taxpayer did not recognize any income from Year 2 through Year 3 with respect to the amounts held in the Trust Accounts at the time of the Year 3 Sale or with respect to the Pre-Need Receivables existing at the time of the sale. Further, prior to the Year 3 Sale, the Taxpayer had incurred no costs related to the Pre-Need Contracts other than certain costs that it deducted for tax purposes in the years incurred.

As part of the Year 3 Sale, Taxpayer transferred the Pre-Need Contracts to Purchaser and Purchaser succeeded to Taxpayer's rights and obligations under the contracts. In conjunction therewith, Taxpayer transferred to Purchaser the Trust Accounts and the Pre-Need Receivables, and Purchaser assumed Taxpayer's obligations to provide the merchandise and services specified in the Pre-Need Contracts.

In computing its gain from the Year 3 Sale on the Form 4797 attached to its Year 3 Form 1120S, Taxpayer included in its adjusted basis for its business an amount equal to the net of (1) the aggregate amount in the Trust Accounts, plus (2) the amount of the Pre-Need Receivables, less (3) its estimated cost to provide the merchandise and services specified in the Pre-Need Contracts. Because this net amount was positive, Taxpayer's inclusion of these amounts in its computation of its adjusted basis increased the adjusted basis it claimed on its Year 3 Form 4797 and reduced the gain from the Year 3 Sale it reported on its Year 3 Form 1120S.

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[1] Taxpayer represents that State A law did not require that payments received from a customer on a Pre-Need Contract be held in trust for the customer.

LAW AND ANALYSIS:

Taxpayer's treatment and reporting related to the Pre-Need Contracts is illustrated by the following example involving a single hypothetical Pre-Need Contract:

(1) On March 15, Year 2, Taxpayer entered into a Pre-Need Contract with Customer A. Pursuant to the contract, Taxpayer agreed to furnish after Customer A's death specified merchandise and services, which Taxpayer estimated would cost $2,000, and Customer A agreed to pay a total of $4,000 for the merchandise and services. Prior to the Year 3 Sale, Customer A paid $3,000 to Taxpayer, which Taxpayer deposited in a Trust Account and treated as held in trust for Customer A. Accordingly, the Pre-Need Receivables with respect to Customer A at the time of the Year 3 Sale were $1,000. Customer A was alive as of the time of the Year 3 Sale.

(2) Prior to the Year 3 Sale, Taxpayer did not recognize any income with respect to its Pre-Need Contract with Customer A.

(3) As part of the Year 3 Sale, Taxpayer transferred its Pre-Need Contract with Customer A to Purchaser. In conjunction therewith, Taxpayer transferred to Purchaser the Trust Account containing the $3,000 that it had received from Customer A, the $1,000 of Pre-Need Receivables reflecting the portion of the contract price still to be received from Customer A, and the obligation to provide after Customer A's death funeral merchandise and services that Taxpayer estimated would cost $2,000.

(4) Taxpayer included in its adjusted basis for its business for purposes of determining its gain from the Year 3 Sale $2,000 with respect to its contract with Customer A. This amount equaled (1) the $3,000 received from Customer A that was held in the Trust Account, plus (2) the $1,000 of Pre-Need Receivables related to the contract, less (3) the $2,000 estimated cost of performance.

Section 1001(a) of the Internal Revenue Code provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market

value of the property (other than money) received. Section 1.1001-2(a)(1) of the Income Tax Regulations provides that, except as provided in paragraph (a)(2) and (a)(3) of that section, the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(3) provides that in the case of a liability incurred by reason of the acquisition of property, that section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

Section 1011 provides, with exceptions not relevant in this case, that the adjusted basis for determining gain shall generally be the basis determined under § 1012, adjusted as provided in § 1016. Section 1012 provides, with exceptions not relevant in this case, that the basis of property shall be the cost of such property. The adjustments to basis set forth in § 1016 are not relevant in this case.

In determining that its adjusted basis for its funeral home business was $b (as it reported on the Form 4797 attached to its Year 3 Form 1120S), Taxpayer erroneously claimed an adjusted basis for the Pre-Need Contracts equal to the net of (1) the amount in the Trust Accounts, plus (2) the amount of the Pre-Need Receivables, less (3) its estimated cost to provide the merchandise and services specified in the contracts. With respect to the first two items, Taxpayer did not recognize as income for tax purposes the Pre-Need Receivables and the amount in the Trust Accounts. With respect to the third item, Taxpayer incurred no costs in connection with its obligations to provide the merchandise and services specified in the contracts. Thus, Taxpayer had no basis in the Pre-need Contracts related to these items. Further, Taxpayer incurred no other costs in connection with the Pre-Need Contracts other than costs it deducted for tax purposes in the years incurred. Thus, Taxpayer overstated its adjusted basis for its business, as determined under § 1012, when it included the net of these amounts therein. As a result, Taxpayer underreported the amount of its gain from the Year 3 Sale by the net amount.

Our conclusion that Taxpayer overstated its adjusted basis for its business when it included therein as its adjusted basis for the Pre-Need Contracts the net of the three amounts described above is consistent with the economic substance of the transaction. The Pre-Need Contracts had value as of the time of the Year 3 Sale. That this is so may be illustrated with the facts of the hypothetical contract described above. Performance of that contract by Taxpayer would have entitled it to receive $4,000 (the $3,000 that the Taxpayer held in the Trust Accounts for Customer A and treated as belonging to Customer A, plus the additional $1,000 still owed by Customer A at the time of the Year 3 Sale), at a cost (assuming the Taxpayer's estimate of its cost of performance proved accurate) of $2,000, yielding a positive cash inflow of $2,000.

Simply put, the contract had value to Taxpayer because, assuming that the customer did not cancel it and request a refund, the contract entitled Taxpayer to a net cash inflow of $2,000. The contract may have been even more valuable to others who believed they could perform the contract at a lesser cost.

In computing an amount realized from the Year 3 Sale of $a (as it reported on the Form 4797 attached to its Year 3 Form 1120S), Taxpayer did not include any amount therein related to it being relieved from the obligations to provide merchandise and services in accordance with the Pre-Need Contracts as a result of Purchaser's assumption of such obligations. Taxpayer's determination to not include in its amount realized any amount with respect to relief from these obligations was proper under § 1.1001-2(a)(3) because those obligations were not taken into account in determining its basis for the Pre-Need Contracts.

Taxpayer contends alternatively that, if it had reported too large an adjusted basis as a result of including in its adjusted basis the net of the three amounts described above (as we have concluded it did), then it also reported too large an amount realized from the Year 3 Sale. Taxpayer contends that this is so because it failed to reduce the $a amount realized it reported by the amounts held in the Trust Accounts that were transferred to Purchaser. Taxpayer contends that this should have been done because when the Trust Accounts were transferred to Purchaser, they offset a portion of the $a that Taxpayer received from Purchaser. Taxpayer's contention that the funds in the Trust Accounts belonged to it, and thus offset a portion of the cash it received from Purchaser, is inconsistent with the manner in which Taxpayer treated those funds for all other tax purposes – i.e., as continuing to belong to its customers. Because Taxpayer treated these funds as belonging to its customers, it would be inconsistent to treat them as belonging to it for purposes of determining its gain from the Year 3 Sale. Therefore, the funds in the Trust Accounts were not available to offset any portion of the consideration Taxpayer received from Purchaser and Taxpayer did not overreport the amount realized from the sale of its funeral home business.

We express no opinion on the tax treatment of the Year 3 Sale under the provisions of any other section of the Code or regulations that may apply. Specifically, we express no opinion on the propriety of Taxpayer's method of allocating the consideration received for its assets in the Year 3 Sale. Further, we express no opinion on the propriety of Taxpayer's method of accounting for the initial sale of the Pre-Need Contracts to customers under § 451 or any other section of the Code or regulations that may apply.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.