THE TREATMENT OF CONTINGENT LIABILITIES
IN TAXABLE ASSET ACQUISITIONS

I. INTRODUCTION

This outline discusses the Federal income tax treatment of contingent liabilities in the context of taxable asset acquisition transactions.

A. First, the outline will provide a brief overview of the timing rules relating to deductions.

B. Then, the outline will discuss the treatment of contingent liabilities in the context of taxable asset acquisitions. This topic is of particular interest, since the importance of contingent liabilities has increased dramatically in recent years. Common examples of contingent liabilities include environmental liabilities, employee health care and pension liabilities, and tort liabilities. The outline will highlight the factors traditionally relied on in determining whether a liability of the seller has been assumed by the buyer as part of an acquisition.

1. Unfortunately, the treatment of contingent liabilities is currently uncertain due to the fact that traditional authorities are sparse and often contradictory.

2. The parties face significant tax issues and risks where an acquisition involves contingent liabilities.

a. The concerns of the seller include:

(1) Whether additional gain must be recognized;

(2) Whether the installment method will apply;

(3) Whether an offsetting deduction can be claimed; and

(4) Whether interest income will be imputed.

b. The concerns of the buyer include:

(1) Whether the contingent liabilities can be deducted;

(2) Whether income to the buyer will be triggered; and

(3) Whether the imputed interest rules will apply.

II. TIMING OF DEDUCTIONS

A. Accrual Method Taxpayers

1. An accrual method taxpayer may deduct an expense when:

    a. The "all events" test of section 461(h)(4) has been satisfied, and

    b. Economic performance has occurred.

2. The all events test of section 461(h)(4) is satisfied when the liability is "final and definite in amount, fixed and absolute, and unconditional." United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), citing Security Flour Mills Co. v. Commissioner, U.S. 281, 287 (1944), Brown v. Helvering, 291 U.S. 193, 201 (1934) and Lucas v. North Texas Lumber Co., 281 U.S. 11, 13 (1930).

    a. The first two components of the above rule are referred to as the "all events" test, which originated in United States v. Anderson 269 U.S. 422 (1926), and is now codified in section 461(h)(4).

        (1) The all events test is intended to protect against deductions that might never occur. Diversified Auto Services. Inc. v. Commissioner, 43 T.C.M. 701 (1982).

        (2) Generally, accrual for tax purposes is prevented if there exists a contingency with respect to a liability. See TAM 8741001, modified by TAM 9125001.

3. The "economic performance" requirement was added to the all events test with the enactment of section 461(h) in 1984.

    a. Special rules apply where property or services are provided to the taxpayer.

        (1) Section 461(h)(2)(A)(i) provides that if the liability in question arises out of services to be rendered to the taxpayer by another person, economic performance occurs as the services are provided.

        (2) Section 461(h)(2)(A)(ii) provides that if the liability arises out of providing property to the taxpayer by another person, economic performance occurs as the person provides such property.

(3) Section 461(h)(2)(B) provides that where the liability requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

(4) Section 461(h)(2)(C) provides that if the liability requires a payment to be made to another person, and arises under any workman's compensation act or tort claims, then economic performance generally occurs as the payments are made.

4. The timing of deductions may be controlled by other provisions.

a. Section 404(a)(5) provides that contributions to a nonqualified deferred compensation plan are deductible only in the taxable year in which an amount attributable to the contribution is includible in the gross income of the employee.

b. Section 267 may defer deductions between related parties.

c. Treas. Reg. § 1.461-1(a)(2) provides that an accrual method taxpayer cannot claim an immediate deduction for an expenditure that creates an asset with a useful life extending beyond the taxable year.

B. <u>Cash Method Taxpayers</u>

1. Cash basis taxpayers may generally claim a deduction in the year of payment, Treas. Reg. § 1.461-1(a)(1), hence, the "all events test" described above does not apply.

2. However, cash basis taxpayers are still subject to the capitalization rules of Treas. Reg. § 1.461-1(a)(1) for any expenditure that results in the creation of an asset having a useful life extending beyond the taxable year.

3. Moreover, cash basis taxpayers may be denied an immediate deduction if the cash outlay is used to prepay otherwise deductible expenses. For the treatment of such expenditure see <u>Keller v. Commissioner</u>, 725 F.2d 1173 (8th Cir. 1984); Rev. Rul. 79-229, 1979-2 C.B. 210.

III. TREATMENT OF CONTINGENT LIABILITIES IN TAXABLE ASSET ACQUISITIONS

There exists significant uncertainty surrounding the treatment of contingent liabilities in taxable asset acquisitions.

A. Traditional Approach and Development

1. Almost every deal involves the existence of contingent liabilities. Most commonly, these liabilities take the form of environmental costs, pending or future tort claims, and employee costs (i.e., medical, retirement, and unemployment). However, determining the proper treatment of contingent liabilities in taxable asset acquisitions is a complex task due to the sparse and often conflicting authorities that have dealt with the topic. This section discusses both the Federal income tax treatment of contingent liabilities in taxable asset acquisitions and the issues and risks inherent in every taxable asset deal involving contingent liabilities.

2. The issue of the proper treatment of contingent liabilities arises where a buyer purchases the assets of a business and after the acquisition, the buyer pays or incurs a liability that is attributable to the acquired business.

3. Under these facts, it is not clear whether the liability is a liability of the seller that is assumed by the buyer or whether it is simply a liability arising after the acquisition that is properly treated as the buyer's liability.

4. Thus, the threshold question is with whom did the liability arise? Specifically, is it a liability that arose only after the buyer had completed the transaction or is it a liability that originated with the seller and was assumed by the buyer as part of the transaction?

    a. If the buyer did not assume the liability as part of the acquisition then:

        (1) The buyer should get a deduction for the payment of the liability under the usual rules (i.e., deductible within whatever limitations apply, such as sections 404 or 461); and

        (2) The seller should remain unaffected.

b. However, numerous issues arise if the liability is treated as seller liability assumed by the buyer, including:

(1) What is the seller's amount realized on the sale of the business?

(2) Is the seller permitted a deduction to offset any increase in amount realized?

(3) What is the buyer's new basis, if any, in each asset acquired?

5. Once again, the threshold question is when will a contingent liability be treated as a seller liability assumed by the buyer and, alternatively, when will the liability be treated as a buyer liability.

a. Each case must be decided on its own particular set of facts and circumstances.

b. Although this can be an uncertain process, cases and rulings have provided some guidelines or factors as to when a contingent liability will be treated as having been assumed by the buyer.

B. <u>Factors that Determine Whether Liability Has Been Assumed</u>

1. <u>The Liability Results From Buyer's Operation</u>

a. The first factor to be considered in determining whether the buyer assumed the liability of the seller is whether the liability relates to either: (i) the buyer's operation of the business; or (ii) an activity performed by the buyer; or (iii) events under the buyer's control; or (iv) a decision of the buyer.

b. The goal is to separate the occurrence of the liability from the seller (i.e., arising from the seller's operation of the acquired business) and connect the liability to some post-acquisition event or action occurring under the buyer's operation of the acquired business.

c. If the liability does not relate to the seller's operation of the business then the buyer can deduct the costs of the liability incurred (and, in general, the seller should remain unaffected).

d. However, the cost of the liability must be capitalized if it is found to relate to the seller's operation of the business.

e. The primary case that relied on this factor is Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946).

(1) In Holdcroft, a corporation acquired assets from a partnership in exchange for common stock and the assumption of the partnership liabilities, including two tort claims filed against the partnership. This transaction was effected under the predecessor to section 351.

(2) The taxpayer-petitioner settled the tort claims and deducted the costs. At trial, the taxpayer argued that the corporation was the successor to the partnership and that it should be able to deduct amounts paid on the tort claims.

(3) The Eighth Circuit rejected this argument in holding that the claims arose out of the business of the seller, not the buyer.

(4) As a result, the cost of settling the tort claims was not a deductible operating expense or operating loss of the buyer's business.

(5) The Court also held that it was of no consequence that the liabilities were contingent.

(6) NOTE: The Service has announced that it will not follow the Holdcroft decision in situations where the assets of a business are acquired in a section 351 transaction. Rev. Rul. 95-74, 1995-2 C.B. 36; See also Rev. Rul. 80-198, 1980-2 C.B. 113; Rev. Rul. 83-155, 1983-2 C.B. 38. Relying upon its ruling in Rev. Rul. 80-198, the Service, in Rev. Rul. 95-74, explained that the specific congressional intent of section 351(a), which is to facilitate the incorporation of ongoing businesses through a tax-free vehicle, would be frustrated if Holdcroft was followed under these circumstances.

(a) Hence, the Service will not disallow deductions under Holdcroft that arise out of pre-acquisition operations if the business was acquired in a section 351 transaction.

(b) However, Rev. Rul. 95-74 only explicitly applies to section 351 transactions and, therefore, the factor created in Holdcroft is still applicable to taxable transactions.

(c) Moreover, it is important to note that while the Service will not apply <u>Holdcroft</u> in section 351 transactions, courts may still continue to do so.

(7) In Notice 2001-17, 2001-09 I.R.B. 730, the Service announced that it will not follow Rev. Rul. 95-74 in certain tax shelter transactions defined under the Notice. <u>See also</u> Notice CC-2001-033a, (June 28, 2001) (advising field personnel on how to develop cases involving stock loss claims as described in Notice 2001-17, 2001-09 I.R.B. 730, on contingent liability tax shelters).

(a) The tax shelter transaction, which is intended to qualify under section 351, involves a transfer of a high basis asset to a controlled corporation in exchange for stock and the assumption of a liability with a present value only slightly less than the value of the transferred asset.

(b) The stock received in the transaction has a low fair market value because the value of the liability is almost equal to the value of the transferred asset

(c) However, the transferor's basis in the transferee's stock is not reduced by the assumed liability because the transferred liability is not treated as money received by virtue of sections 358(d)(2) and 357(c)(3).

i) Section 357(c)(3) excludes the amount of a liability, the payment of which would give rise to a deduction, from the determination of the amount of liabilities assumed.

ii) Section 358(d)(2) excludes liabilities described under section 357(c)(3) from being treated as money received by the taxpayer on the exchange.

(d) The transferor then sells the acquired stock for its fair market value, which is far less than the transferor's basis in the stock, and claims a loss on the sale.

(e) For transfer's after October 18, 1999, the Service will assert that such losses are disallowed because the transferor's basis in the stock received is reduced under newly enacted section 358(h), which reduces stock basis by the amount of certain liabilities.

f. Other authorities seem to focus on this factor-

(1) In Illinois Tool Works, Inc. v. Commissioner, 117 T.C. No. 4 (2001), the court held that the payment of a patent infringement liability assumed by the buyer must be capitalized.

(a) In so holding, the court stated "[g]enerally, the payment of a liability of a preceding owner of property by the person acquiring such property, whether or not such liability was fixed or contingent at the time such property was acquired, is not an ordinary and necessary business expense." Id. at 11.

(b) The court rejected the taxpayer's contention that the payment should retain its deductible character because it would have been deductible had it paid by the seller prior to the acquisition.

(c) The court also rejected the taxpayer's argument that the payment of the liability should not be added to basis because the liability was highly spectulative and unexpected at the time of acquisition.

(d) Instead, the court held that the buyer was aware of the liability, the liability was expressly assumed in the purchase agreement, and the status of the liability was considered in determining the final purchase price.

(2) In Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd, 333 F.2d 653 (2d Cir. 1.964), the court rejected the buyer's attempt to capitalize costs associated with severance payments made to union employees pursuant to a collective bargaining agreement that arose upon the buyer's decision to close a manufacturing plant.

(a) The court emphasized that the liability arose out of a new collective bargaining agreement that was negotiated on behalf of the buyer contemporaneously with the purchase of the business.

(b) The court also emphasized that the new agreement was substantially different from the seller's old agreement to the extent that payments were contingent upon the buyer's failure to provide adequate notice of a plant closing.

(c) Accordingly, the court held that the buyer's obligation was of "such contingent character that it could not be considered part of the cost of the assets," and that any liability that became fixed in a later year was properly taken into account as a deduction.

(3) In TAM 9721002 (Jan. 24, 1997), the buyer expressly assumed the liabilities of the business. The Service determined that:

(a) [I]n the precedent requiring the buyer to capitalize, rather than deduct, the payment of an obligation, the events most crucial to creation of the obligation occur before the acquisition. Under these circumstances, the obligation is treated as a liability of the seller. By contrast, in cases allowing the buyer to take a deduction, the events most crucial to creation of the obligation occur after the acquisition. Under these circumstances, the obligation is a liability of the buyer. The difference in the cases is therefore the degree to which the obligation was fixed at the time of the acquisition.

(b) In the instant case, a liability for severance payments to Target's employees could arise only if employees were involuntarily terminated. As no employee had been terminated by the date of acquisition, no liability existed for New Target to assume. Further, Buyer neither expressly nor impliedly agreed to pay, as part of the acquisition, any severance payments it might later incur. Buyer was free to decide after the acquisition whether to terminate employees and become liable. Finally, some employees would not be entitled to severance under either the termination protection agreements or the personnel policy if other suitable jobs could be found for them.

(c) Hence, this case more closely resembles cases in which the events most crucial to creation of the obligation occurred after the acquisition. Because no employee was terminated before the date of acquisition, no liability arose before the acquisition (even though the amount of New Target's later liability for severance pay could be based on employment status and length of service with Target). Thus, the severance payments did not result from liabilities of Target, either fixed or contingent, that New Target could be treated as assuming in the acquisition.

(4) In Rev. Rul. 76-520, 1976-2 C.B. 42, the buyer acquired a newspaper business.

(a) The Service held that the costs of fulfilling prepaid subscriptions were assumed by the buyer and had to be capitalized because the liability related to the seller's operation of the business.

(b) However, the Service also held that costs incurred for publication and distribution to news stands were deductible because they related to the buyer's operation of the business.

(5) In FSA 19991068 (October 8, 1993), the buyer acquired the assets and assumed the liabilities of a packaging company.

(a) The Service concluded that the buyer must capitalize post-acquisition payments made for retiree health and life insurance benefits.

(b) The Service based its conclusion on the fact that the benefits were paid to retirees who had never worked for the buyer.

(c) Accordingly, the Service determined that "[Buyer's] obligation to pay those benefits could not have arisen out of the operation of its business, but arose instead out of employment contracts the former employees had with the seller."

(d) The Service also concluded that expenses incurred by the buyer in closing a plant were deductible because the buyer was under no obligation to make post-acquisition closings and thus, the expenses incurred therefor were not liabilities assumed by the buyer.

2. Arises Out of Post-Acquisition Events

A second factor is whether the liability arises out of post-acquisition events. This factor is closely related to the one discussed above and commonly arises in employee death benefit cases.

a. This factor has been relevant where there is a contract in place at the time of the acquisition to pay death benefits when an employee dies.

   (1) The liability is contingent because the employee will one day die.

   (2) The liability should be a buyer liability if the employee dies after closing.

   (3) However, the buyer has assumed the liability if the employee has died prior to the acquisition.

b. Several cases illustrate this point.

   (1) In M. Buten & Sons, Inc. v. Commissioner, 31 T.C.M. 178 (1972), a corporation agreed to assume the liabilities of a partnership including death benefits payable to widows.

      (a) The taxpayer was not allowed a deduction for death benefits payable to the widow of an already deceased partner.

      (b) However, the taxpayer could deduct death benefits payable to the widow of a partner who died after the acquistion.

   (2) In David R.Webb Company, Inc. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983), the buyer assumed an obligation to make pension payments to the wife of an employee that had died almost twenty years prior to the acquisition.

      (a) The court held that the obligation arose prior to buyer's operation of the business.

      (b) The buyer was, therefore, not permitted to deduct death benefits paid under this obligation.

3. <u>Buyer Aware of Liability</u>

The third factor is whether the buyer was aware of the liability at the time of the acquisition.

a. In <u>Pacific Transport Co. v. Commissioner</u>, 29 T.C.M. 133 (1970), <u>rev'd</u> <u>per curiam</u>, 483 F.2d 209 (9th.Cir. 1973), <u>cert. Denied</u>, 415 U.S. 948 (1974), a parent corporation liquidated its subsidiary acquiring the assets and assuming the liabilities, which included law suits asserted against the subsidiary.

(1) The Tax Court held that the liabilities were not assumed because they were too remote to be accounted for.

(2) The Ninth Circuit disagreed holding that the acquiring parent was aware of the liabilities at the time of the liquidation and, therefore, the liabilities constituted capitalized costs of the acquisition.

(3) The court further held that the contingency was irrelevant, stating that no exception to capitalization treatment applies where "taxpayers enter into bargains, proceed under a mistake of, law, or fail to realize the substance or amount of the liability assumed."

b. <u>Pacific Transport</u>, suggests that the buyer will not be entitled to a deduction if it is aware of the liability prior to the acquisition.

c. It is uncertain whether the buyer in <u>Pacific Transport</u> would have been permitted a deduction had it not known of the liabilities.

d. The Tax Court's recent holding in <u>Illinois Tool Works</u>, <u>supra</u>, also suggests that pre-acquisition knowledge of a potential liability justifies capitalization.

(1) The taxpayer argued that it ought to be permitted to deduct the payment of an assumed potential patent infringement liability because both the likelihood of the liability vesting and the amount of the liability if vested were highly speculative.

(2) The court disagreed, stating that the liability "was a contingent liability that petitioner was aware of prior to the acquisition of assets and liabilities from [the seller] and that petitioner expressly assumed in the purchase agreement." <u>Id.</u> at 17.

e. The Holdcroft decision supra, seems to indicate that the buyer's knowledge of the liability is irrelevant to the extent that the facts and circumstances of the case indicate that the liability arose from the operations of the seller.

f. Moreover, it seems quite certain that while the Service will consider the buyer's awareness of the liability as a factor, the main test of deductibility is whether the liability arose out of the buyer's operation of the business. See 1997 FSA LEXIS 327 (Dec. 10, 1997) ("It is not enough that the buyer is aware of the liability. Rather, it must be determined whether the liability arose out of a post-acquisition event").

g. NOTE: Pacific Transport, was recently questioned by the Seventh Circuit in Nahey v. Commissioner, 196 F.3d 866 (7th Cir. 1999).

(a) In Nahey, the court rejected the taxpayer's claim for capital gains treatment and held that settlement proceeds paid to the buyer for a liability arising out of the seller's operation of the business constituted ordinary income to the buyer when received.

(b) In so holding, the court stated: "In some of the cases that Nahey cites, the court may have misclassified an expenditure (he points chiefly to Pacific Transport Co. v. Commissioner, . . .) and treated an ordinary expense as a capital one. If so (and we needn't decide), those cases are incorrect."

(c) Judge Cudahy concurring opinion argues that "Pacific Transport is on all fours with the present case except that it involves the expense side rather than the income side." Accordingly, Judge Cudahy acknowledges that it is inequitable for the government to assert capitalization in the expense context and ordinary income in the income context when the claims at issue are the complete inverse of one another.

(d) In Illinois Tools Works, supra, the Tax Court recently declined to rule upon the statues of Pacific Transport. Instead, the court ruled that the issue was controlled by David R Webb, which is the main Seventh Circuit case regarding the treatment of assumed liabilities.

4. <u>When Did Legal Liability Arise</u>

Another factor used by some courts to determine if a liability of the seller has been assumed by the buyer is the time the legal liability arose.

a. This factor explains the treatment of contingent tort liabilities.

b. Courts have typically held that legal liability for a tort arises when the tort occurs.

   (1) As a result, a pre-acquisition cause of action is a liability of the seller.

   (2) <u>Holdcroft</u>, <u>supra</u>, <u>Pacific Transport</u>, <u>supra</u>, and <u>Illinois Tool</u>, <u>supra</u>, support this conclusion.

   (3) These cases also indicate that the contingent nature of the claim is irrelevant.

c. This result should be compared to the treatment of claims arising in contract.

   (1) In <u>Albany Car Wheel Co.</u>, <u>supra</u>, there was a collective bargaining agreement that required payment of severance wages to employees upon a plant shutting down.

      (a) The purchase agreement called for an express assumption of the severance pay liability.

      (b) After the acquisition, the plant was shut down and severance payments were made by the buyer.

      (c) The court held that the liability did not arise until after the buyer had closed the plant.

      (d) The contract that required payment upon certain events was contingent upon a future event; the liability arose only after the plant was closed down.

      (e) Thus, the buyer's payments of severance costs were deductible because the contingency occurred from the buyer's operation of the business since the liability arose from the buyer's decision to close a manufacturing plant without giving the contractually required notice.

      (f) This decision is instructive because it indicates that:

i) The facts and circumstances of the transactions override the express assumption of a liability;

ii) A contingent liability arising in contract may not treated as an assumed liability; and

iii) A deduction is appropriate if the action that triggers the contingency is within the buyer's control (in this case, shutting down the plant).

(2) The same result was reached in <u>United States v. Minneapolis & St. Louis Ry. Co</u>, 260 F.2d 663 (8th Cir. 1958).

(a) The seller was in negotiations with a labor union for retroactive wage increases.

(b) The balance sheet contained a reserve for the retroactive wages to be paid once a settlement was reached.

(c) The agreement with the union was reached after closing; the liability arose at that point.

(d) The court held that there was no liability of the seller to assume and the buyer's payment of the retroactive wages was deductible.

(e) NOTE: The balance sheet reserve was not an issue in the case.

5. <u>Liability Reflected in Price</u>

The next factor is whether the contingent liability is reflected in the price of the acquired assets of a business.

a. Courts look to see if the purchase price was reduced on account of the existence of contingent liabilities.

b. If purchase price appears to have been reduced, then the liability looks more like an assumed liability. <u>But see</u> <u>Pacific Transport</u>, <u>supra</u> (acknowledging that the purchase price had not been reduced by the value of the liability but finding in favor of assumption nonetheless).

c. This factor is most evident where:

(1) There is a reserve on the company's balance sheet prior to the acquisition for the amounts of a liability that is not currently deductible (e.g., employee retirement and medical benefits owed);

(2) Where the purchase price is based upon the company's balance sheet (e.g., book value of assets minus the anticipated cost of liabilities); and

(3) Where there is a clear reduction in purchase price allowing the Service to argue that the liability is reflected in the cost.

6. Liability Expressly Assumed by the Buyer

The next factor is whether the Buyer has expressly assumed a liability of the seller.

a. If the Buyer expressly assumes the liabilities of the seller, it is generally concluded that the buyer has assumed the liability as part of the acquisition, therefore, requiring capitalization

b. However, this factor alone is not always fatal to the buyer's chances of deducting liability costs.

c. For example, in Minneapolis & St. Louis Ry. Co., supra, the buyer purchased assets of a business and assumed all the liabilities of a business at a foreclosure sale.

(1) The Eighth Circuit affirmed the Tax Court in upholding a buyer-taxpayer's deduction for retroactive wage increase payments.

(2) The court held that the liability could not have been assumed because it did not exist at the time of acquisition.

(3) This case implies that an express assumption of liabilities will not result in capitalization if the facts and circumstances of the liability indicate that the liability could not have been assumed.

d. In Albany Car Wheel Co., supra, the buyer made severance payments to terminated employees after the buyer decided to close a manufacturing plant.

(1) The purchase agreement required that the buyer procure a release of the seller's liability under a union contract for severance pay.

(2) The buyer procured the release by entering into a new contract for severance pay, which had terms that substantially differed from the seller's contract.

(3) The court held that the liability had not been assumed because the liability arose out of the buyer's conduct, which obligated the buyer under its own contract.

e. In TAM 9721002 (Jan. 24, 1997), the Service ruled that the buyer's express assumption of an obligation to make severance payments under a pre-acquisition agreement did not preclude a deduction because the liability arose solely out of the buyer's decision to terminate employment.

f. In GCM 39274 (Aug. 16, 1984), the Service ruled that the buyer's express assumption of an obligation to fund a past service liability did not preclude the deductibility of the buyer's own contributions paid in order to meet post-acquisition minimum funding requirements.

7. Balance Sheet Reserve

The last factor is the balance sheet reserve. This factor can be viewed as a combination of:

a. The buyer's awareness of the claim, and

b. Reflections in purchase price.

8. Summary

The seven factors that determine whether the buyer has assumed the liability of the seller are:

a. Whether the liability results from the buyer's operation of the business;

b. Whether the liability arises out of post-acquisition events;

c. Whether the buyer was aware of the liability at the time of the acquisition;

d. Whether the legal liability arose before or after the acquisition;

e. Whether the liability is reflected in the price of the acquired business assets;

f. Whether the buyer has expressly assumed the liability; and

g. Whether the liability is reflected in the seller's balance sheet.

IV. <u>TREATMENT OF ASSUMED LIABILITIES</u>

Once it is determined that the buyer has assumed a liability of the seller, the tax treatment to both the buyer and seller must be determined.

A. <u>Seller's Treatment of an Assumed Liability</u>

1. From the seller's perspective, the first issue pertains to income inclusion.

a. As a general matter, the seller's amount realized is increased when the seller is relieved of a liability.

b. However, it is not clear when the increase should occur and how much of an increase should be reflected in the amount realized.

c. One approach is to value the contingent liability at closing, and increase the seller's amount realized by this value (e.g., closed transaction treatment). <u>See</u> <u>Crane v. Commissioner</u>, 331 U.S. 1 (1947) (amount realized includes the amount owed under a mortgage that is assumed by the buyer); <u>Tufts v. Commissioner</u>, 461 U.S. 300 (1983) (same).

d. A second approach is to increase the seller's amount realized only when the contingency becomes fixed and determinable (the "wait and see" approach).

e. If the wait and see approach applies, the issue arises as to whether the sale is converted into a contingent payment installment sale because of the possible future payment of purchase price when the liability becomes fixed.

(1) The section 453 regulations do not discuss the assumption of contingent liabilities, however, if the liability is treated as part of the payment of the purchase price, then the sale literally falls within the definition of a contingent payment installment sale.

(2) If installment sale treatment applies, the seller presumably would be subject to rules governing contingent payment installment sales. See Treas. Reg. § 15A.453-1(c).

(3) These rules distinguish between three different situations:

  (a) When the maximum selling price is determinable, Treas. Reg. § 15A.453-1(c)(2);

  (b) When the maximum selling price is not determinable but the time over which payments are received is determinable, Treas. Reg. § 15A.453-1(c)(3); and

  (c) When neither the maximum selling price nor the time over which payments are received is determinable, Treas. Reg. § 15A.453-1(c)(4).

(4) ISSUE: Should section 453 apply to sales where the only contingency relates to the assumed contingent liability?

There appears to be no clear answer to this question.

(5) If section 453 does apply, absurd and costly results may follow.

  (a) First, basis is recovered ratably over a 15-year period. Treas. Reg. § 15A.453-1(c)(4).

  (b) Moreover, under the 15-year basis recovery rule, gain is realized in the beginning years with loss potentially deferred until the later years.

(6) Taxpayers can argue that section 453 technically does not apply because it requires a "payment to be received" in a future year. See I.R.C. § 453(b).

  (a) No payment is actually received when a contingent liability becomes fixed.

  (b) Rather, there is constructive payment occurring upon the later relief of the liability.

(7) Taxpayers can avoid this potential hazard by electing out of section 453 where contingent liabilities are assumed. I.R.C. § 453(d).

2. A second issue is whether the seller can offset any increased amount realized with a deduction, so that no net income is realized.

a. Most practitioners would conclude that the seller should get a deduction under James M. Pierce Corp. v. Commissioner, 325 F.2d 67 (8th Cir. 1964), rev'g, 38 T.C. 463 (1962) and Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981).

b. In Pierce, supra, the seller operated a newspaper business.

(1) The seller received prepaid subscription fees, set up a reserve, and deferred the income from the prepayments.

(2) The court held that the reserve was accelerated into income upon the sale of the business under section 455.

(3) However, the court permitted the seller to take an offsetting deduction in the amount of the accelerated income.

(4) The rationale of the court:

(a) The seller realized income when the buyer's assumption extinguished the reasons for the subscription reserves.

(b) But a corresponding deduction was proper because the sales price was reduced to reflect the buyer's assumption of the liability.

(c) Therefore, the reduction in sales price created as much of an out-of-pocket payment to the seller as if buyer had paid cash for the reserve and the seller then turned around and paid the buyer for assuming the liability to fill newspaper subscriptions.

c. In Commercial Security Bank, supra, a slightly different rational was used to permit a seller to deduct unpaid expenses that were assumed by the buyer.

(1) The court stated that the liabilities assumed by the buyer reduced the amount of cash received by the seller.

(2) The court then held that such a reduction in cash received is treated as if the seller actually paid the liability.

(3) Thus, the seller was permitted an offsetting deduction to compensate for the amounts actually paid.

d. PROBLEM- The seller can have all kinds of liabilities. It is, therefore, important to also consider the rules that determine the timing of deductions because, under these rules, an offsetting deduction may be deferred (e.g., under sections 404(a), 461(h)), or not available at all.

(1) For example, does the seller still get a deduction if the all events test is satisfied but there has been no economic performance?

(2) The section 461(h) regulations reserve treatment of contingent liabilities. Treas. Reg. § 1.461-4(j).

(3) The regulations do provide that in a sale of a business -- if the buyer "expressly assumes" a liability -- economic performance occurs as the amount of the liability is properly included in the seller's amount realized. Treas. Reg. § 1.461-4(d)(5)(i); 4(g)(1)(ii)(C).

(a) However, this regulation may not always apply to contingent liabilities because its narrow language requires an express assumption.

(b) If the test under these regulations is failed, the seller may have income without a matching deduction and, presumably, the deduction is deferred until the buyer pays the liability.

i) This is not the proper result; in the acquisition context, the seller should not be subject to economic performance.

ii) Section 461(h) is intended to prevent premature accrual of deductions, however, the accrual is not premature if the seller has income recognition.

iii) Moreover, it is not a clear reflection of income if the seller has accelerated income without a matching deduction.

(4) QUERY: Whether <u>Pierce</u>, <u>supra</u>, and <u>Commercial Security Bank</u>, <u>supra</u>, apply if the section 461(h) regulations do not.

(a) In TAM 8939002 (June 15, 1989), the Service ruled that <u>Pierce</u> and <u>Commercial Security Bank</u> are not dispositive of deferred compensation deduction issues because section 404(a) removed such deductions from general tax accounting and deduction rules.

(b) The Service did not question the validity of either holding, rather, it ruled that Pierce and Commercial Security will not apply where deductibility is controlled by the rules of a specific code section.

(c) Hence, it appears that the Service will allow Pierce and Commercial Security to apply if treatment is not specifically accounted for elsewhere under the code.

(5) Other problems arise where the liability is for payments to a nonqualified deferred compensation plan.

(a) Under section 404(a)(5), the deduction occurs only when the employee is in receipt of the payment and realizes income.

(b) The deduction may, therefore, be deferred until such time as the income vests with the employee.

(c) As mentioned above, this was the position taken by the Service in TAM 8939002, supra.

3. Finally, a third issue facing the seller is whether interest will be imputed on the deemed payment resulting from a contingent liability that becomes fixed.

a. This issue occurs under the wait and see approach.

b. The taxpayer could argue that section 1274 does not apply (assuming the debt is not modified) to impute interest. Section 1274(c)(4); Treas. Reg. § 1.1274-5(a).

c. QUERY: Whether interest could be imputed under section 446.

4. Summary

a. Income - The liability is either valued at the time of the sale or when the contingency becomes fixed and determinable.

b. Wait and See - If the wait and see approach applies, then the installment sale rules may apply unless an election out of section 453 is made.

c. Offsetting Deduction - The seller may get a deduction to offset income, however, the timing of the deduction may not match the inclusion in income.

d. Imputed Interest Income - If the wait and see approach applies, the seller may have imputed interest income.

B. <u>Buyer's Treatment of Assumed Liabilities</u>

There are three different approaches that can be used to determine how and when a buyer should include the value of an assumed liability in basis.

1. <u>Capitalization Approach</u>

a. Under this approach, the liability is treated as a part of the cost of the assets and gets added to basis when the liability becomes fixed.

b. This approach is supported by <u>David R. Webb</u>, <u>supra</u>.

(1) The buyer expressly assumed an unfunded pension liability as part of the acquisition.

(2) The liability was to make payments to the widow of a deceased employee.

(3) The payments were treated as a cost of the acquired assets that had to be capitalized.

c. Other cases supporting this approach include <u>Holdcroft Transportation</u>, <u>supra</u>; <u>Pacific Transport</u>, <u>supra</u>; <u>M. Buton & Sons</u>, <u>supra</u>; and <u>Illinois Tool Works</u>, <u>supra</u>.

d. The capitalization approach has the greatest support in the case law.

e. It remains uncertain whether the buyer can treat a portion of each payment as interest.

2. <u>Deduction Approach</u>

a. Under this approach, the buyer gets a deduction (subject to such limitations as sections 404 or 461(h)) when the liability becomes fixed, even if the buyer expressly assumed that liability as part of the acquisition.

b. This position does have some support in case law.

(1) Albany Car Wheel Co., supra.

(a) The purchase agreement specifically stated that the liability in question was being assumed by the buyer.

(b) However, the court held that the facts and circumstances of the transaction showed that the liability had not been assumed and the liability to pay severance wages arose out of the buyer's conduct and decisions.

(c) The buyer was permitted to deduct the costs of the liability.

(2) Minneapolis & St. Louis Ry. Co., supra.

(a) The agreement of purchase at foreclosure expressly stated that the buyer assumed all liabilities of the seller.

(b) However, the taxpayer was permitted to deduct amounts expended on retroactive wage increases that related to services performed while in the employ of the seller because the liability did not arise until after the business had been purchased.

(c) While this case suggests the use of the deduction approach, it can also be read as holding that no liability was in fact assumed.

(3) F. & D. Rentals. Inc. v. Commissioner, 44 T.C. 335 (1965), aff'd, 365 F.2d 34 (7th Cir. 1966), cert. denied, 385 U.S. 1004 (1967).

(a) The taxpayer argued that the mere assumption of a pension liability itself constituted payment of the liability for purposes of section 404(a).

(b) The Tax Court disagreed, holding that an assumption of a liability was not the equivalent of payment.

(c) On appeal, the Eighth Circuit affirmed the Tax Court's holding and stated, in dictum, that the "taxpayer would have been entitled to a pension plan deduction if it had made a payment in the taxable year here in question or by the time it had filed its return."

(4) Both the American Bar Association and the New York State Bar Association support deduction treatment.

3. <u>Income Approach</u>

a. Under this approach, the buyer includes the amount of the assumed liability in income, which is later offset by a deduction when the liability is satisfied.

b. This approach stems from <u>James M. Pierce Corp. v. Commissioner</u>, <u>supra</u>.

(1) The seller sold the assets of a newspaper business.

(2) The court required the seller to include the amount of a reserve for prepaid subscription fees in income on the sale of the business.

(3) The court then permitted an offsetting deduction under the theory that there had been a deemed payment from seller to buyer in the amount of the reserve.

(4) The court, in dicta, stated that the buyer may have income on receipt of deemed payment from the seller.

c. The Service agreed with this approach in Rev. Rul. 71-450, 1971-2 C.B. 78.

(1) The Service concluded that the buyer had income equal in amount to the deemed payment by the seller.

(2) The Service also ruled that the buyer could defer income under section 455 and deduct the costs when paid.

d. EXAMPLE: Assume that a buyer acquired a business having gross assets of $100 with a tax basis of $30, and a $20 liability for unpaid subscriptions. The buyer pays $80 in cash for the business.

(1) The buyer is treated as paying $100 to the seller for the assets (the $80 payment grossed-up for the $20 liability).

The buyer currently receives basis in the acquired assets of $100.

(2) The seller has $70 of gain ($100-$30) and receives a deduction of $20 for the deemed payment to the buyer (for the assumption of the unfilled subscription liability).

(3) The buyer, therefore, has $20 of current income.

(4) The buyer then gets a deduction for subsequent expenditures incurred in filling the subscriptions.

e. This approach generally has not been applied outside of the publication industry (where section 455 allows the buyer to defer recognition of the deemed income).

4. Summary

a. Capitalization Approach- This approach has the most authority, however, there remains the issue of whether the buyer gets a deduction for payment of imputed interest.

b. Deduction Approach- This approach is supported by the least amount of authority and many of the cases that seem to support it can also be read as holding that no liability was in fact ever assumed.

c. Income Approach- This approach has some authority, however, it tends to apply only to the publishing cases.

C. Section 1060

1. Overview

Section 1060 provides special allocation rules for certain applicable asset acquisitions.

a. Applicable Asset Acquisitions

(1) An applicable asset acquisition is defined as any transfer (whether directly or indirectly)

(a) Of assets which constitute a trade or business, see Treas. Reg. § 1.1060-1(b)(2) (for the definitions of trade or business), and

(b) With respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).

(2) Once an applicable asset acquisition has occurred, both the seller and the buyer must allocate consideration received or paid, respectively, in accordance with section 338(b)(5) and the regulations there under. Section 1060(a); Treas. Reg. § 1.1060-1(a).

(a) Consideration is defined under Treas. Reg. § 1.1060-1(c)(1) as:

i) The seller's consideration - the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b).

ii) The buyer's consideration- the amount, in the aggregate, of the cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

b. <u>Allocation of Consideration</u>

Sellers and buyers must allocate the consideration using the "residual method" under Treas. Reg. §§ 1.338-6, -7 in order to determine the amount realized and basis, respectively, of each asset. Treas. Reg. § 1.1060-1(c)(2).

(1) The allocation of consideration is governed by Treas. Reg. § 1.338-6.

(2) The amount of consideration allocated to an asset cannot exceed that assets fair market value.

(3) There are seven classes of assets to which the consideration may be allocated:

(a) Class I assets consist of cash and general deposit accounts.

(b) Class II assets consist of certificates of deposits, U.S. government securities, readily marketable stock and securities, and foreign currency. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock defined in section 1504(a)(4).

i) NOTE: The temporary regulations in affect for asset acquisitions occurring on or after January 6, 2000 and before March 16, 2001 prior to January 6, 2001 permitted stock of target affiliates to qualify as Class II assets.

(c) Class III -- assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include --

i) Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;

ii) Contingent debt instruments subject to Treas. Reg. § 1.1275-4, Treas. Reg. § 1.483-4, or section 988, unless the instrument is subject to the non-contingent bond method of Treas. Reg. § 1.1275-4(b) or is described in Treas. Reg. § 1.988-2(b)(2)(i)(B)(2); and

iii) Debt instruments convertible into the stock of the issuer or other property.

iv) NOTE: The temporary regulations define Class III assets as consisting of accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.

(d) Class IV assets consist of stock in trade of the taxpayer or other property of a kind which would be included in the inventory of the taxpayer, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(e) Class V assets consist of all assets other than Class I, II, III, IV, VI, VII assets.

(f) Class VI assets consist of all section 197 intangibles, as defined by section 197, except goodwill and going concern value.

(g) Class VII assets consist of goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible). Treas. Reg. § 1.338-6(b).

c. NOTE: If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of consideration or fair market value to any asset, such agreement is binding upon both parties. Treas. Reg. § 1.1060-1(c)(1).

2. Treatment of Assumed Contingent Liabilities Under Section 1060

Section 1060 treatment seems to follow the traditional approach outlined above. Therefore, the buyer and seller both face problems similar to those highlighted above.

a. Seller's Treatment

(1) The regulations under 1060 (as well as Treas. Reg. §§ 1.338-6, -7) do not account for the treatment of contingent liabilities.

(2) However, Treas. Reg. § 1.338-7(a) does state that the consideration is "redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law."

(a) Although this regulation appears to suggest that the "wait and see" approach discussed should apply, the regulation also expressly states that the redetermination must be taken into account "under general principles of tax law."

(b) As a result, the seller's amount realized should not be redetermined if the parties value the contingent liability at the time of acquisition and the amount realized is increased accordingly.

(c) Thus, the traditional approach will apply unless the contingent liability is valued, and the seller accounts for the increase in its amount realized, at closing.

(3) If the consideration is redetermined, the additional consideration is allocated under the rules of Treas. Reg. § 1.338-6. Treas. Reg. § 1.338-7(b)

b. Buyer's Treatment

(1) The buyer, like the seller, must redetermine the amount of consideration paid under Treas. Reg. § 1.338-7(a) and allocate it in accordance with Treas. Reg. § 1.338-6.

(2) This tends to suggest that the buyer must use the capitalization approach described above to account for contingent liabilities that become fixed after the acquisition date.

(3) However, Treas. Reg. § 1.338-7(a) does state that the redetermination must be taken into account "under general principles of tax law."

i) As a result, the buyer could argue that one of the other traditional approaches described above should apply.

ii) Also, no redetermination should be necessary if the contingent liabilities are valued and added to basis at the time of closing.

D. Section 338(h)(10)

1. Overview

Once there has been a Qualified Stock Purchase of Target ("T") stock, the purchasing corporation and the seller (selling consolidated group, selling affiliate or S corporation shareholders) may make a joint election under section 338(h)(10) to treat the sale of T stock as if T sold all of its assets in a single transaction.

a. Result of the Section 338(h)(10) Election

(1) T, while a member of the selling consolidated group, selling affiliate, or S corporation ("Old T"), is treated as selling all of its assets to an unrelated person ("New T") for consideration that includes the discharge of its liabilities (see Treas. Reg. § 1.1001-2(a)), and New T is treated as acquiring all of Old T's assets in exchange for consideration that includes the assumption of Old T's liabilities. Treas. Reg. § 1.338-1(a)(1).

(2) Old T is then treated as transferring all of its assets to the selling consolidated group, selling affiliate, or S corporation and goes out of existence (generally treated as a complete liquidation). Id.

(3) Purchase price and basis are determined in accordance with section 338(b) and the regulations there under.

b. Consequences of a Section 338(h)(10) Election to Seller

(1) No gain or loss will be recognized by members of the selling group on their sale of T stock, rather, Old T will recognize gain or loss as if it had actually sold all its assets while included as a member of the selling group. Treas. Reg. § 1.338(h)(10)-1(d)(3).

(2) As a result, the tax on T's gain resulting from a section 338(h)(10) election is generally paid by the selling consolidated group.

(3) Therefore, the gain recognized by Old T can be offset by the losses, if any, of the selling group but not the purchasing group.

(4) The amount of gain recognized by Old T is ADSP minus basis.

(5) ADSP is determined under Treas. Reg. § 1.338-4 and is equal to:

(a) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock; and

(b) The liabilities of Old T. Treas. Reg. § 1.338-4(b).

i) The grossed-up amount realized is equal to:

a) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if the selling shareholder(s) were required to use Old T's accounting methods and the installment method were not available;

b) Divided by the percentage of T stock (by value, determined on the acquisition date) attributable to that recently purchased stock;

c) Minus the selling costs incurred by the selling shareholder(s). Treas. Reg. § 1.338-4(c).

ii) The liabilities of Old T are measured as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338-4(d).

a) In order to be taken into account, a liability must be a liability of the target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. See Treas. Reg. § 1.338-4(d)(1) (citing Treas. Reg. § 1.1001-2(a)).

b) Such liabilities may include liabilities for the tax consequences resulting from the deemed sale, however, this is rare in section 338(h)(10) transactions.

(6) ADSP is then allocated under the residual method in accordance with Treas. Reg. § 1.338-6 to determine the nature and amount of gain or loss on each asset deemed sold. <u>See</u> <u>infra</u> Part IV.C.1.b.

(7) ADSP may be redetermined under Treas. Reg. § 1.338-7 at such time as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. Treas. Reg. § 1.338-4(b)(2)(ii).

c. Consequences of a Section 338(h)(10) Election to Buyer

(1) No gain or loss is recognized by the buyer on the purchase of T stock.

(2) New T's basis in its assets will be revalued to reflect the purchase price paid by the purchasing corporation for the T stock. Treas. Reg. § 1.338(h)(10)-1(d)(2).

(3) New T's basis is the AGUB.

(a) AGUB is determined under Treas. Reg. § 1.338-5 and is equal to:

i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

ii) The purchasing corporation's basis in nonrecently purchased target stock; and

iii) The liabilities of New T. Treas. Reg. § 1.338-5(b).

(b) The grossed-up basis in recently purchased stock equals:

i) The purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regards to costs incurred;

ii) Multiplied by a fraction:

a) The numerator- 100 minus the number that is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock;

b) The denominator- the number equal to the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's recently purchased target stock;

iii) Plus the acquisition costs incurred by the purchasing corporation in the transaction. Treas. Reg. § 1.338-5(c).

(c) The liabilities of New T are the liabilities of Old T as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338-5(e).

i) In order to be taken into account, a liability must be a liability of the target that is properly taken into account in amount realized under general principles of tax law.

ii) Such liabilities may include liabilities for the tax consequences resulting from the deemed sale, however, this is rare in section 338(h)(10) transactions.

(4) AGUB is then allocated under the residual method in accordance with Treas. Reg. § 1.338-6 to determine the nature and amount of gain or loss on each asset deemed sold. See supra at Part IV.C.1.b.

(5) AGUB may be redetermined under Treas. Reg. § 1.338-7 at such time as an increase or decrease would be required, under general principles of tax law, for the elements of AGUB. Treas. Reg. § 1.338-5(b)(2)(ii).

2. Treatment of Assumed Contingent Liabilities Under Section 338(h)(10)

a. The section 338 regulations are designed to ensure that deemed asset acquisitions are treated similarly to actual asset acquisitions.

b. Accordingly, the treatment of contingent liabilities to both the buyer and seller under the section 338(h)(10) regulations should follow the treatment imposed upon the buyer and seller in applicable asset acquisitions. See supra Parts III.C.2 and 3.

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TABLE OF CONTENTS