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Contingent Consideration and Contingent Liabilities in Acquisitions: Outline, Addendum, References

Robert H. Wellen

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CONTINGENT CONSIDERATION AND CONTINGENT LIABILITIES IN ACQUISITIONS

OUTLINE
ADDENDUM
REFERENCES

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ROBERT H. WELLEN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.
CONTINGENT CONSIDERATION
AND CONTINGENT LIABILITIES
IN ACQUISITIONS

OUTLINE

OCTOBER 1999

ROBERT H. WELLEN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.

TABLE OF CONTENTS

INTRODUCTION ........................................................................................................................... 1
NOMENCLATURE ........................................................................................................................ 2
TAXABLE ASSET AND STOCK ACQUISITIONS ..................................................................... 3

I. Contingent Purchase Price in Acquisitions of Assets and Stock Without Section 338(h)(10) Election ................................................................. 3
   A. Treatment of Seller of Assets or of T Stock — Choice Between Installment Method and Election Out .......................................................... 3
   B. Treatment of T — Election Out of Installment Method .................................................... 3
      1. Amount Realized at Closing .......................................................................................... 3
      2. Amount Realized and Timing — Character .................................................................. 4
      3. Amount Realized and Timing — Open Transactions ..................................................... 4
      4. Allocation of Amounts Realized Among Assets Sold ....................................................
   C. Treatment of Seller — Installment Sale Method ................................................................. 5
      1. Application ....................................................................................................................... 5
      2. Election ............................................................................................................................ 5
      3. Deferral Charge .............................................................................................................. 5
      4. Method of Reporting ..................................................................................................... 6
      5. Allocating Installment Note to Some Assets ................................................................ 8
      6. Net Benefits and Detriments of Installment Sale Method to Seller ............................... 8
      7. Legislative Proposal ..................................................................................................... 9
   D. Treatment of A .................................................................................................................... 9
      1. Allocation of Contingent Purchase Price Among Assets Purchased ............................ 9
      2. Specific Allocations — Intangible Assets .................................................................... 9
      3. Timing of Effects on Basis ............................................................................................. 9
E. Reporting Requirements.............................................................................................................. 10
1. Section 1060 Acquisitions........................................................................................................ 10
2. Installment Method — Electing Out........................................................................................... 11
3. Installment Method..................................................................................................................... 11

II. Contingent Purchase Price in Stock Acquisitions with Section 338(h)(10) Elections........... 11
A. Treatment of Old T.................................................................................................................... 11
   1. Installment Method Not Available.......................................................................................... 11
   2. Amount Realized at Closing................................................................................................. 12
   3. Amount Realized Upon Receipt.............................................................................................. 12
   4. Allocation of Amounts Realized Among Assets Deemed Sold............................................... 12
   5. Recovery of Asset Basis.......................................................................................................... 12
   6. Character of Amounts Realized — Actual and Imputed Interest.......................................... 12
B. Treatment of New T................................................................................................................... 12
   1. Allocation of Contingent Purchase Price Among Assets Purchased..................................... 12
   2. Timing of Effects on Basis....................................................................................................... 13
C. Reporting Requirements........................................................................................................... 13

III. Escrows and Other Returns of Purchase Price..................................................................... 13
A. Whose Property Is the Escrow?............................................................................................... 14
   1. Inclusion of Escrowed Funds in Seller’s Amount Realized at Closing................................. 14
   2. Income on Escrowed Funds.................................................................................................... 14
B. If Escrow Is A’s Property.......................................................................................................... 15
   1. Treatment at Closing to Seller............................................................................................... 15
   2. Treatment at Closing to A....................................................................................................... 15
   3. Income Earned on Escrowed Funds........................................................................................ 15
   4. Treatment on Payment to Seller............................................................................................. 16
   5. Treatment on Return of Escrowed Funds to A........................................................................ 16
C. If Escrow Is Seller’s Property.................................................................................................. 16
   1. Treatment at Closing to Seller............................................................................................... 16
   2. Treatment of Escrow at Closing to A..................................................................................... 17
   3. Income Earned on Escrowed Funds........................................................................................ 17
   4. Treatment on Payment to Seller............................................................................................. 17
   5. Treatment on Return of Escrowed Funds to A........................................................................ 17
D. If Escrowed Property Is Stock of A or A’s Parent.................................................................... 17
   1. Taxable Gain to A.................................................................................................................... 17
   2. Tax on Dividends................................................................................................................... 18
IV. Contingent Liabilities in Taxable Asset Acquisitions

A. Introduction........................................................................................................................ 18

B. Whose Liability? Contingent Liability or Defect in Assets? What Is at Stake?............. 18
   1. T’s or A’s Liability — Consequences.............................................................................. 18
   2. Alternative Analysis......................................................................................................... 18
   3. Authorities...................................................................................................................... 18
   4. Authorities on Employee/Retiree Compensation and Benefits...................................... 20
   5. T Employee Stock Options, SARs and Severance Pay................................................... 21

C. Treatment if A’s Liability.................................................................................................. 21
   1. Treatment at Closing and upon Payment by A................................................................. 22
   2. Treatment of Indemnity Payment by T........................................................................... 22

D. Treatment If T’s Liabilities Assumed — Current Law...................................................... 22
   1. Non-Deductible Items..................................................................................................... 22
   2. Currently Deductible Items............................................................................................ 23
   3. Delayed Deductible Items.............................................................................................. 24
   4. Capital Items of T........................................................................................................... 24
   5. Treatment of Indemnity by T........................................................................................... 25

E. Treatment If T’s Liabilities Assumed — Pierce Analysis............................................... 25
   1. Prior Use.......................................................................................................................... 25
   2. Current Consequences..................................................................................................... 25
   3. Limits on Use of the Pierce Analysis................................................................................. 26

F. Treatment If T’s Liabilities Assumed — Alternative Analyses......................................... 26
   1. A Steps into T’s Shoes....................................................................................................... 26
   2. Surprise Expenses.......................................................................................................... 27
   3. Discounted Deduction...................................................................................................... 27
   4. Possible IRS Guidance.................................................................................................... 27

V. Taxable Stock Acquisitions.............................................................................................. 27

A. General.............................................................................................................................. 27

B. Contingent Liabilities as Built-in Loss............................................................................ 27
   1. Section 382(h)................................................................................................................ 27
   2. Consolidated Return Matters........................................................................................ 27

C. Negative Investment Adjustments to A for Contingent Liabilities................................... 28
D. Treatment of Receipt of Contingent Stock by Former T Shareholders — Effect on Basis of A Stock.................................................................33

E. Effect of Non-Receipt by Former T Shareholders..................................................33

IX. T's Contingent Liabilities 33

A. Possible Effect of Assumption of T's Contingent Liabilities on Tax-Free Reorganization Status — the “Acquiring Corporation”.................................33
   1. The “Acquiring Corporation.” ........................................................................33
   2. “Cause-to-Direct” Acquisitions. .................................................................33

B. Deductions to A and Related Matters...............................................................33
   1. “Step-in-the-Shoes.” ................................................................................33
   2. Exception. ..................................................................................................34
   3. Section 351 Exchanges ..............................................................................34
   4. Indemnities..................................................................................................34
CONTINGENT CONSIDERATION
AND CONTINGENT LIABILITIES
IN ACQUISITIONS

OUTLINE

OCTOBER 1999

ROBERT H. WELLEN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.

This Outline does not take into account the proposed regulations published by the Treasury Department and the Internal Revenue Service on August 10, 1999. The proposed regulations would significantly change the tax treatment of applicable asset acquisitions under section 1060, and stock sales with elections under section 338(g) and 338(h)(10). The Addendum to this Outline discusses the proposed regulations.

INTRODUCTION

Nearly all business acquisitions have loose ends. The seller and buyer may not agree on a final purchase price for simple reasons like the need to adjust for balance sheet changes to the date of closing. Or there may be contingent purchase price payments like earn-outs or purchase price escrows. Similarly, there may be costs of or claims against the purchased business that cannot be precisely quantified, such as environmental clean-up obligations, employee benefit items, tax deficiencies or commercial claims for which the buyer might be held responsible. This outline discusses the Federal income tax consequences of these loose ends.

The law in this area contains a number of surprises for those who have not considered these issues before. As examples:

- The installment sale method often results in less tax deferral than one might suppose. There may even be acceleration of tax.

- A seller of a business entitled to contingent purchase price payments will be better off selling the stock of a subsidiary with a section 338(h)(10) election, as opposed to having the subsidiary sell its assets.

- The seller of a business whose contingent liabilities are being assumed may have to continue to follow the fortunes of the business, even if he is not liable (e.g., under indemnities). These liabilities may cause an increase in the seller's gain (or a decrease in the loss) from the sale of the business, and offsetting deductions may not occur at the same time.

- The buyer of a business that is obligated to make purchase price payments based on sales, earnings or the like (or even royalty or rent payments) may have to allocate these
payments to goodwill with 15-year amortization, rather than treat them as deductible royalties or rents.

- The buyer of a business must capitalize rather than deduct many post-closing expenses that seem routine.

- The buyer of a business may even have to recognize taxable gain at closing to account for contingent liabilities being assumed.

- Under recent proposed regulations, if any purchase price is placed in escrow, the buyer is taxed on income earned on the escrowed funds until it is determined which party will receive the funds. If a dispute develops, and the funds come under court jurisdiction, the escrow fund is taxed as a separate entity.

- On the other hand, escrowed stock in a tax-free acquisition is considered to belong to the former target shareholders — unlike escrows in taxable acquisitions under the new proposed regulations.

- In a taxable stock sale, if the target company has contingent liabilities that are retained by the seller (e.g., through indemnities), two deductions may result — a capital loss to the seller and an ordinary deduction to the target.

- In a tax-free reorganization with contingent stock, imputed interest will be taxed to the former shareholders of the target corporation, but this interest may not be deductible to the acquiring corporation.

**NOMENCLATURE**

In this outline the following nomenclature is used to designate the parties to a transaction:

- **T** = Corporation whose assets are sold to A; corporation whose stock is sold (with or without a section 338(h)(10) election); or corporation acquired by A in a tax-free reorganization.

- **Old T** = Deemed seller of assets in a section 338(h)(10) stock sale.

- **New T** = Deemed purchaser of assets in a section 338(h)(10) stock sale.

- **S** = Parent corporation or other shareholder of T; seller of T stock.

- **Seller** = T, Old T or S, as the case may be.

- **A** = Purchaser of T assets; or purchaser of T stock (with or without a section 338(h)(10) election); or corporation acquiring T in a tax-free reorganization.

- **P** = Parent corporation of A.
TAXABLE ASSET AND STOCK ACQUISITIONS

I. Contingent Purchase Price in Acquisitions of Assets and Stock Without Section 338(h)(10) Election.

A. Treatment of Seller of Assets or of T Stock — Choice Between Installment Method and Election Out. A Seller of assets or of T stock in a taxable acquisition with a contingent purchase price reports gain (not loss) on the installment method, unless it elects out. The installment method does not apply to a contingent payment obligation, however, if the obligation represents a retained interest in the property, an interest in a joint venture or partnership, an equity interest in a corporation, or another similar non-sale transaction. Reg. § 15a.453-1(c)(1). See Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976) (no joint venture when seller indemnified buyer for earnings shortfall).

B. Treatment of Seller — Election Out of Installment Method.

1. Amount Realized at Closing.

   a. General Rule.

      i. If Seller elects out of the installment method, gain will be recognized under Seller’s normal method of accounting. At the date of sale Seller must realize the fair market value of the right to the contingent payments. In TAM 9853002 (undated), IRS compared this result to the results under the installment method, taking the deferral charge of section 453A into account. The Service concluded that the results should be economically comparable. See part I.C.3., below.

      ii. In determining the fair market value of the contingent purchase price outside the installment method, Seller must take all contingent payment attributes into account. Reg. §1.1001-2(g)(ii). By contrast, under the installment method, in determining the fair market value of the obligation, restrictions on transferability are disregarded, and the value of the obligation cannot be less than the fair market value of the property sold (less any other consideration received). Reg. § 15a.453-1(d)(2)(i) and (ii).

   b. Possible Open Transaction Treatment of Sales. The regulations permit Seller to wait and see only “in rare and extraordinary cases” in which the fair market value of the contingent payments is not “reasonably ascertainable.” Reg. § 1.1001-2(g)(2)(ii). In these “rare and extraordinary cases,” the open transaction doctrine applies. Burnet v. Logan, 283 U.S. 404 (1931). Open transaction treatment means no amount is realized until payment is actually received (cash method taxpayers), or until all events occur which fix the right to receive the payment and the amount can be determined with reasonable accuracy (accrual method taxpayers). Amounts realized first would be applied against basis, deferring gain recognition to Seller...
until all basis is recovered. See part I.B.3., below. This treatment is most advantageous to Seller, as compared with the general rule (see part I.B.1.a., above) and the installment method (see part I.C., below). Thus, a Seller can be expected to use open transaction treatment wherever possible.

c. Possible Open Transaction Treatment of Royalty Transactions. In connection with a sale of its business, Seller may retain ownership of intangible property (e.g., patents and trademarks) and license their use by A for contingent payments based on use or productivity of the property. Seller would recognize income from the royalties when the amounts are paid or fixed. This treatment applies only if Seller retains sufficient ownership rights in the property such that the arrangement qualifies as a true license of the intangible, not an installment sale. Code section 1253; Rev. Rul. 55-540, 1955-2 C.B. 39 (sale v. lease). By contrast, if the transaction is a sale, and if Seller does not elect out of the installment method, Seller generally would recognize gain as payments are received (see part I.C., below). If Seller does elect out, Seller would recognize gain at closing on the fair market value of the contingent payments, unless they cannot be valued (see parts I.B.2. and 3., below). For treatment of A, see part I.D., below.


a. Section 1274. When payments are received (cash method), or when the right to the payments becomes fixed and the amounts can be determined with reasonable accuracy (accrual method), Seller discounts the payments under section 1274 to the date of sale to determine the principal and interest portions of the payment. Reg. § 1.1275-4(c)(4)(ii). Some of the principal portion is recovery of basis on the debt instrument, and the rest is gain. If the total amount received is less than the basis of the instrument, Seller will recognize loss. If Seller is on the accrual method, and if A makes the payments more than 6 months after they became fixed, interest accrues on original issue discount. Reg. § 1.1275-4(c)(4)(iii). The parties may state an interest rate, so long as that rate is as high as or higher than the applicable Federal rate (AFR).

b. Section 483. Similar principles apply if the debt instrument is subject to section 483, except that interest is taxed only when received. Section 483 generally applies to small transactions and in other specifically-designated situations. Section 483 also applies to contingent debt before it becomes fixed, so that, during this time interest accretes but is not taxable to Seller or deductible to A until the contingency becomes fixed. Section 483 also applies to contingent stock received in tax-free acquisitions. See part VIII.C., below.

3. Amount Realized and Timing — Open Transactions. In the "rare and extraordinary" case where Seller's contingent payment right is not susceptible to valuation, the transaction would remain open, and, when the amounts become includible under Seller's method of accounting, Seller would discount the amount and recognizes additional gain, plus interest.
4. **Allocation of Amounts Realized Among Assets Sold.** The total selling price, including contingent payments, is allocated among all assets, tangible and intangible. Under section 1060, increases in consideration (Seller’s amount realized) are allocated among assets under the residual method. Decreases in consideration are allocated in reverse section 1060 order: first to goodwill (Class V), then to other intangibles (Class IV), etc. Reg. § 1.1060-1T(e), (d), and (f). Section 1060 applies if A’s basis in the transferred assets constituting a trade or business is determined solely by reference to the consideration paid for the assets. Section 1060(c) (“applicable asset acquisition”).

C. **Treatment of Seller — Installment Sale Method.**

1. **Application.** The installment method may apply to a sale with a contingent purchase price if at least one payment is to be received after the close of the taxable year of the sale. Installment method reporting is not available, however, on sales producing a loss to Seller. The loss must be taken in the year of sale. Also ineligible for the installment method are sales of certain property such as publicly traded property and depreciable property to the extent of recapture. Code §§ 453(f)(2), (f)(7). Thus, reporting requires an asset-by-asset determination on availability. Does the fact that A assumes contingent liabilities, without more, make a sale eligible for the installment method? See parts I.C.4.c.i., I.C.4.d.v. and IV.D., below.

2. **Election.** If a sale is eligible, installment method reporting is mandatory unless the seller elects out by reporting the full gain on a timely filed return (including extensions).

3. **Deferral Charge.**

   a. Installment sales in excess of $5 million are subject to an interest charge at the underpayment rate (Federal short-term rate plus three percentage points). Code § 453A. Thus Sellers in large transactions usually obtain little or no advantage from the installment method and so elect out. In an installment sale involving contingent purchase price, Seller can end up paying a deferral charge on gain from purchase price never received.

   b. The deferral charge can be based on more than the actual sale price. In TAM 9853002 (undated), T sold assets to A for a note based on cash flow. In reporting its deferred gain under section 453A, T estimated that it would receive the maximum amount of the note and paid a deferral charge based on this amount. Later, market conditions deteriorated, and T determined that it would receive much less than the maximum. T amended its prior-year return to seek a refund of deferral charge. IRS denied the refund, concluding that T should not be allowed to adjust its deferral charge retroactively. Reg. § 15A.453-1(c)(7), which allows alternative basis recovery did not apply for two reasons: First, T did not request an advance ruling. Second, this regulation allows adjustment to timing, not
amount, of income. This result seems harsh, but it is probably no more harsh than the result that occurs if Seller elects out of the installment method. See part I.B.1.a., above.

4. **Method of Reporting.** If the installment method is used, gain is recognized as each payment is received. The amount of gain allocable to each payment is determined under section 453(c) by allocating basis in proportion to the amount of such payment. The treatment of contingent payments under the installment sale rules depends on whether the contingent payment is limited as to amount, as to timing or neither. If payments received with respect to contingent liabilities are considered part of the purchase price, the installment sale method would apply, forcing delay in Seller’s recovery of a portion of its basis until the payments are received. Accordingly, open transaction treatment (available in the context of a stock sale with a section 338(h)(10) election - see part II., below) is more favorable to Seller because it avoids valuation problems and permits delaying gain until all basis has been recovered.

   a. **Amount Realized at Closing.** Receipt of the installment obligation does not constitute a taxable event, irrespective of Seller’s method of accounting.

   b. **Amount Realized Upon Receipt of Payment.** To the extent payments are received at closing or later, Seller reports as gain amount by which the payment (excluding interest) exceeds the allocable portion of basis. The amount realized at the time of each payment is the proportion of the payment that the gross profit (realized or to be realized) bears to the total contract price. Code § 453(c).

   Payments received are considered to include interest at the AFR, if no interest is stated. Reg. §§ 1.1274-1(b), -4. Thus, Seller may report on the installment method only the principal portion of contingent payments discounted to the date of sale using the AFR (or higher interest rate in the purchase agreement).

   c. **Allocation of Amounts Realized Among Assets Sold.** The total selling price, including contingent payments, is allocated among all assets, tangible and intangible. Reg. § 1.1060-1T(d).

      i. **Increases in Purchase Price.** Under section 1060, increases in Seller’s consideration (its amount realized) are allocated among assets under the residual method. Reg. § 1.1060-1T(f)(2). This treatment would seem to apply to payments by A of assumed contingent liabilities that are treated as purchase price adjustments. Does this treatment mean that every acquisition of a business with contingent liabilities is an installment sale? See parts I.C.4.d.v. and IV.D., below.

      ii. **Decreases in Purchase Price.** Decreases in Seller’s consideration are allocated in reverse section 1060 order: first to goodwill (Class V), then to other intangibles (Class IV), etc. Reg. § 1.1060-1T(f)(3). But no refund of section 453A deferral charge is allowed. See part I.C.3.b., above.
d. Recovery of Asset Basis. In most cases, contingent purchase price arrangements are limited by total amount, by time, or by both. Basis recovery depends on which limitation, if either applies.

i. Maximum Selling Price. If the contingent payment is subject to a maximum, then, for purposes of allocating basis among payments, the total maximum selling price is assumed to be the selling price. Reg. § 15a.453-1(c)(2)(i). The purchase agreement is read assuming all contingencies are resolved to maximize the selling price and accelerating payments to their earliest possible date (although if later events reduce the maximum price, it can be recomputed, even to an amount below the seller’s adjusted basis, producing a bad debt deduction). Reg. § 15a.453-1(c)(2)(i)(A). Because this method defers basis recovery and accelerates gain, it may not be in Seller’s interest, from a tax viewpoint, to negotiate a maximum cap much above the amount of payments it is likely to receive.

ii. Time Limitation. If no maximum selling price can be determined but the contingent payment is limited to a specific time period, basis generally is recovered in “equal annual increments” during the time contingent payments can be received. Reg. § 15a.453-1(c)(3). If a payment received in any one year is less than the basis allocated for that year, there is no loss allowed, and instead the amount of unrecovered basis is to be carried forward to the following year. Reg. § 15a.453-1(c)(3).

In ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff’d 157 F.3d 231 (3d Cir. 1998), a taxpayer tried to take advantage of the ratable basis recovery under these regulations with respect to certain debt obligations purchased and sold in a multiple party financing arrangement. The sale produced losses for certain partners in the later years of the fixed recovery period. The Tax Court and the Third Circuit both found the transaction to be a sham in substance and denied the loss, but neither court expressed an opinion as to whether the regulation otherwise permitted such basis recovery.

iii. No Maximum Selling Price or Time Limitation. A contingent payment not limited by a fixed period or maximum selling price first is analyzed to determine whether in substance a sale occurred and the payment is a debt from A to Seller. If so, basis generally is recovered ratably over 15 years. Reg. § 15a.453-1(c)(4). Basis in excess of the amount of a payment in any given year is carried forward to the next year, and to future years if necessary; no loss is permitted. Reg. § 15a.453-1(c)(4). T may try to convince IRS that the straight line allocation inappropriately defers recovery of seller’s basis, although there is the risk that the Service might lengthen the recovery period, as well. The test is whether the rule “would substantially or inappropriately defer or accelerate” recovery.
iv. **Impact of Loss Assets, Etc.** Losses are not deferred under the installment method. Nor are gains on sales of inventory, depreciation recapture, etc. *See* part I.C.1., above. Contingent purchase price is allocated among all assets alike, within a class, regardless of whether the sale of the asset is eligible for the installment method. Thus, for example, the portion of a contingent payment allocated to a loss asset must be valued and will reduce the loss recognized at closing. As a result, the net benefit of the installment method may be less than one might assume.

v. **Impact of Assumed Contingent Liabilities.** If A assumes contingent liabilities in an asset purchase, the assumption could be viewed as contingent purchase price that would invoke the basis recovery rules of the installment sale method. *See* part I.C.4.c.i., above, and part IV.D., below. For example, if A assumes T’s contingent liabilities with no cap or time limit, must T recover its asset basis over 15 years, unless it receives IRS permission to do otherwise or elects out of the installment method?

e. **Character of Amounts Realized — Actual and Imputed Interest.** Payments received are subject to the imputed interest rules under section 483 or section 1274, unless the parties specify that the payments include interest at a rate at least equal to the AFR. Actual or imputed interest is separately includible to the seller when received and deductible to A when paid.

5. **Allocating Installment Note to Some Assets.** Seller should be able to allocate contingent consideration to goodwill and going concern value (which may have a zero basis) and the cash portion of the purchase price to hard assets. *Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq.*, 1964-2 C.B. 6; Rev. Rul. 68-13, 1968-1 C.B. 195. This ability to recover basis against cash purchase price payments would make the installment method more attractive.

6. **Net Benefits and Detriments of Installment Sale Method to Seller.**

   a. **Benefits.** Installment method reporting may benefit Seller in a small transaction ($5 million or below) by permitting deferral, especially if Seller anticipates receiving only a small amount of payment in the early years of a fixed period, because the basis recovery rules are unlikely to accelerate gain. Seller may not be advantaged by installment method reporting in a large transaction because of the deferred payment charge in section 453A.

   b. **Detriments.** Even in a small transaction, Seller may find the installment method disadvantageous, if the maximum selling price considerably exceeds the amount actually paid after resolution of the contingencies, because of delay in recovering basis. *(But see* part I.C.5., above.) Open transaction treatment is much more advantageous.
7. **Legislative Proposal.** The Administration has proposed repeal of the installment method for accrual basis taxpayers. U.S. Treasury Department, General Explanations of Administration Revenue proposals (February 1999), 146. This provision was included in legislation adopted by both the House and the Senate but vetoed by the President. H.R. 2488, 106th Cong., 1st Sess. (1999), Section 1508; S. 1429, 106th Cong., 1st Sess. (1999), Section 1313. More recently, it has been included in a proposal to extend expiring provisions. JCS, Description of Modified Chairman’s Mark Relating to Expiring Tax Provisions, JCX. 73-99 (October 20, 1999).

D. **Treatment of A.** From A’s perspective, an acquisition involving a contingent purchase price is accorded “open transaction” treatment. It makes no difference whether Seller uses the installment method or elects out. Even though Seller elects out and so must recognize the fair market value of contingent payments (or use the installment method), A gets no basis for contingent payments until the payments are made, or until the contingency is fixed. Reg. §§ 1.461-1(a)(1), (2).

1. **Allocation of Contingent Purchase Price Among Assets Purchased.** Under section 1060, A’s consideration is the cost of the assets acquired in the applicable asset acquisition. Reg. § 1.1060-1T(c).

   a. **Increases in Purchase Price.** Additional payments generally are allocated among the transferred assets, but only up to the fair market value of the assets and so tend to make their way to Class V assets (goodwill). Reg. § 1.1060-1T(f)(2).

   b. **Decreases in Purchase Price.** Purchase price decreases generally are allocated in reverse order, starting with Class V. Reg. § 1.1060-1T(f)(3). Decreases in purchase price can lead to “phantom income” on fast-turning Class III assets (e.g., inventory and receivables), because purchase price is allocated within a class in proportion with the fair market value of all assets in the class. See part I.D.3.b., below.

2. **Specific Allocations — Intangible Assets.** If the specific allocation of an increase or decrease in consideration results from a contingency directly related to a particular intangible asset – such as a patent, secret process, or copyright – and not to other assets, a specific allocation of the adjustment may be made to the price of that intangible, up to its fair market value (re-determined at the time the increase or decrease is taken into account). Reg. § 1.1060-1T(f)(4). See part I.D.3.c., below.

3. **Timing of Effects on Basis.** When a contingent payment of additional purchase price is made, to apportion the payment between principal and interest, A discounts the payment using the same rules in section 483 or section 1274 that apply to Seller. See part I.B.2., above. A deducts the interest portion and adds the principal portion to its basis in the assets or stock purchased. Note the asymmetry between A’s and Seller’s treatments, especially if Seller elects out of the installment sale method.
a. **Upward Basis Adjustments.** A is entitled to make an upward basis adjustment upon making an additional purchase price payment to T. Because the space beneath the fair market value “cap” of the Class II to Class IV assets is likely filled, the increased basis adjustment generally will be made to goodwill (Class V), recoverable over the remainder of the 15-year amortization period from the date of sale.

b. **Recovery Methods and Periods — Tangible Assets.** If a considerable portion of A’s cost is contingent, A may be forced to allocate a portion of its cost attributable to the contingent payments among the Class III assets, including inventory and receivables. This means that A cannot allocate its cost up to the full fair market value of certain high turnover assets on the date of sale. If A disposes of such Class III assets before the contingent payments are paid or fixed, A may have “phantom” income to the extent its amount realized exceeds its allocated portion of cost. See part I.D.1., above.

c. **Recovery Methods and Periods — Purchased Intangible Assets.** If a particular intangible asset merits a specific allocation of the purchase price adjustment (see part I.D.2., above), A re-determines the adjusted basis in the intangible and claims amortization deductions over the remainder of the 15-year period under section 197. Reg. §§ 1.1060-1T(c), (d); Proposed Reg. § 1.197-2(f)(2).

d. **Recovery Methods and Periods — Contracts for Use of Intangibles.** Section 197 does not apply to amounts that are otherwise deductible. Proposed Reg. § 1.197-2(a)(3). Pre-section 197 case law suggests that, to the extent the purchase price paid for certain types of intangible assets can be shown to pertain to a particular taxable year, the amounts paid may be immediately deductible as paid. *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945) (price of patent based on percentage of income each year); *Holden Fuel Oil Co. v. Commissioner*, T.C. Memo 1972-45, aff’d 479 F.2d 613 (6th Cir. 1973) (contingent payments for customer list deductible when paid). Under *Associated Patentees*, A arguably can claim an immediate deduction for additional purchase price payments tied to performance of the intangible during the taxable year, irrespective of the 15-year period under section 197. The proposed regulations under section 197 seem to eliminate this argument. Proposed Reg. § 1.197-2(b)(11) include in the definition of “section 197 intangible” licenses, contracts, etc., for the use of section 197 intangibles. Proposed Reg. § 1.197-2(f)(3) goes on to provide that amounts paid for the use of intangibles are not deducted currently but are instead amortized over 15 years.

E. Reporting Requirements.

1. **Section 1060 Acquisitions.** In an asset purchase, T and A each must complete a Form 8594, *Asset Acquisition Statement Under Section 1060*, and attach it to their respective returns for the year in which the sale takes place. If the amount allocated to any asset is increased or decreased after the form is filed, the affected parties must
complete Part I and the supplemental statement in Part III of a new Form 8594 and attach it to the return for the year in which the increase or decrease is taken into account. T and A need not agree on the allocation of the purchase price.

2. **Installment Method — Electing Out.** To elect out of the installment method, Seller reports the full amount of the gain on a timely filed return (including extensions), using Form 4797, *Sales of Business Property*, or Schedule D for individuals. There is no formal procedure for electing out where the installment method applies only by virtue of assumption of contingent liabilities. See part I.C.1., above.

3. **Installment Method.** Installment sales are reported on Form 6252, *Installment Sale Income*, filed for each year in which Seller receives a payment from an installment sale, although Part I must be completed only for the year of sale. Once the form is filed, Seller generally cannot later elect out, with the exception that Seller can elect out by filing an amended return reporting the full amount of gain before the end of the six-month extension period, as long as the Form 6252 was timely filed on or before the original due date of the return. Reg. § 301.9100-2(b).

II. Contingent Purchase Price in Stock Acquisitions with Section 338(h)(10) Elections.

This part deals with timing and character of income to T and basis adjustments for A in the context of a purchase of T stock treated as an asset sale and liquidation, pursuant to an election under section 338(h)(10), if purchase price is contingent. The section 338(h)(10) regime allows open transaction treatment to the deemed seller (“Old T”) as well as requiring it for the deemed buyer (“New T”). This rule generally makes a deemed asset sale under section 338(h)(10) more attractive than a straight asset sale, because, in the section 338(h)(10) sale, Seller may wait and see how the contingency is resolved while recovering all asset basis immediately.

Sellers seeking open transaction treatment may be tempted to restructure an asset sale by dropping the assets into a newly-created subsidiary and selling the subsidiary’s stock under a joint section 338(h)(10) election with the buyer. But for the asset drop to be tax free under section 351, sellers must retain “control” of T “immediately after the exchange” by not, for example, entering into a binding commitment or other prearranged integrated plan to sell the T stock to A at the time the assets are transferred. Rev. Rul. 70-140, 1970-1 C.B. 73 (agreement to sell stock in place when assets transferred to subsidiary; *held*, prearranged integrated plan, seller lacked “control”).

A. Treatment of Old T.

1. **Installment Method Not Available.** Technically, the installment method is not available with respect to the deemed asset sale. Upon a section 338(h)(10) election, Old T is deemed to have sold its assets at fair market value to New T and liquidated into its parent. New T is treated as the purchaser of the assets for all tax purposes. Therefore, A’s installment obligation is not an obligation of the purchaser (New T) paid for the assets. This issue will become moot largely if the Administration
proposal to repeal the installment method for accrual basis taxpayers is adopted. See part I.C.7., above.

2. **Amount Realized at Closing.** In contrast to an actual asset sale, in a deemed asset sale Old T may adopt a wait-and-see approach as to the contingency to which future payments of purchase price will be tied. Open transaction treatment, that is ignoring the contingency until it becomes “fixed and determinable” and treating the purchase price as limited to the cash and fixed obligations paid and the fixed liabilities assumed, seems to be mandated by the regulations. Reg. § 1.338(b)-3T(c). Old T may enjoy full basis recovery in the sold assets without having a portion allocated to the value of its contingent right to future payments. This treatment aligns the tax consequences of Old T and New T.

3. **Amount Realized Upon Receipt.** When additional contingent purchase price is paid, the principal amount, discounted from the date of sale, is includible as additional sale proceeds, and the balance is includible as interest at the AFR or at a higher agreed-upon rate.

4. **Allocation of Amounts Realized Among Assets Deemed Sold.** Old T’s amount realized is the fixed portion of the purchase price, allocated among all assets, tangible and intangible, under section 1060. The amount realized first is considered to have been paid for cash and cash equivalents (Class I), then short-term securities (Class II), all other non-assigned assets (Class III), intangibles other than goodwill (Class IV), and finally goodwill (Class V). Reg. §§ 1.338(b)-2T(b), 1.1060-1T(d).

5. **Recovery of Asset Basis.** Old T can recover its full basis in the assets as of the date of deemed sale of assets. Code § 338(h)(10)(A).

6. **Character of Amounts Realized — Actual and Imputed Interest.** A contingent purchase price is treated as a separate contingent debt obligation from New T to Old T. Under the open transaction approach, Old T still determines the amount and timing of interest under the contingent debt obligation rules, discounting back to the date of sale. Reg. § 1.1275-4(c). However, this determination is made when the payment is received or fixed, and the principal component is fully includible in Old T’s amount realized in the year the amount was paid or the contingency became fixed, and the balance would be interest. (Because Old T is deemed to have liquidated, these amounts are taxed to S, Old T’s shareholder.)

B. **Treatment of New T.** From New T’s perspective, a deemed asset purchase involving a contingent purchase price is accorded open transaction treatment, as in a straight asset sale described in part I.D., above. New T gets no basis for the contingent payments until they are paid, or the contingency is fixed.

1. **Allocation of Contingent Purchase Price Among Assets Purchased.** The same rules apply to section 338(h)(10) stock sales as to actual asset sales. See parts I.D.1. and I.D.2., above.
2. **Timing of Effects on Basis.** The same rules apply to section 338(h)(10) stock sales as to actual asset sales. See part I.D.3., above.

   a. **Upward Basis Adjustments.** New T is entitled to make an upward basis adjustment upon making an additional purchase price payment to Old T. Reg. §§ 1.338(b)-3T(f), (g), 1.338(h)(10)-1(e)(5).

   b. **Recovery Methods and Periods — Tangible Assets.** New T allocates each payment, as noted above, among the purchased assets, in section 1060 order. New T adjusts basis in depreciable property and takes depreciation deductions proportionately over the remaining life of the assets. Reg. §§ 1.338(b)-3T(c), 1.338(h)(10)-1(e)(5).

   c. **Recovery Methods and Periods — Intangible Assets.** The principal portion of contingent purchase price increases New T’s purchase price and basis in assets, allocated in section 1060 order, amortizable over remainder of 15-year period. Reg. § 1.338(b)-3T(c). New T may be able to argue that to the extent such allocable payments are deductible, section 197 does not mandate 15-year recovery. Under Associated Patentees, New T may be able to deduct contingent payments pertaining to specific intangibles. But the proposed regulations under section 197 seem intended to eliminate this treatment. See part I.D.3.d., above.

C. **Reporting Requirements.** The section 338(h)(10) election is made jointly by the A and S (or S’s group), by filing a completed Form 8023 by the 15th day of the 9th month beginning after the date of the sale with the IRS district director where the buyer’s headquarters is located. A copy of the completed Form 8023 must be attached to the final income tax return of Old T (or the selling group for the year of sale) and the first return of New T. In contrast to a straight sale of assets, no Form 8594 must be filed, although detailed information is required on Form 8023.

III. **Escrows and Other Returns of Purchase Price.**

   It is common for a portion of the purchase price in an acquisition to be held in escrow for a time. The parties may intend the escrow to secure payments contingent on future events, such as meeting earnings targets, or it may be intended to secure Seller’s indemnity to A for breach of T’s representations or warranties, or for undisclosed liabilities. The issues are whether the amounts placed in escrow are treated as part of the purchase price, to whom income on the escrow funds is taxed, and how adjustments are made once the recipient of the escrowed funds is determined. Recent proposed regulations would determine how income on escrowed funds is taxed and would cause discontinuities in treatment of escrows in some situations. The outcome of other issues depend on case law.
A. Whose Property Is the Escrow? Depending on the nature of the contingency, funds placed in escrow may belong to either T or A for tax purposes.

1. Inclusion of Escrowed Funds in Seller’s Amount Realized at Closing.

   a. Seller’s Liability. If the escrowed funds relate to a liability of Seller, rather than an ongoing problem of the business, they may only benefit Seller and so will be taxed as part of the sales proceeds at closing. *Estate of Steckel v. Commissioner*, 253 F.2d 267 (6th Cir. 1958), *aff’d per curiam* 26 T.C. 600 (1956).

   b. Undisclosed T Liabilities. In other cases, the escrow may protect A against undisclosed or unascertainable liabilities of T’s ongoing business. Here, the law has not clearly stated that Seller will be the owner of the escrow for tax purposes. *See Anderson v. Commissioner*, 20 T.C.M. 697 (1961) (Seller recognizes no income when A places funds in escrow against possible breach of warranty as to undisclosed corporate liabilities). The Service has taken the view, however, that Seller is the owner unless its rights to the funds are subject to substantial restrictions. Rev. Rul. 79-91, 1979-1 C.B. 179; Rev. Rul. 77-294, 1977-2 C.B. 1973. The parties should reach agreement on this point, document it and report consistently.

2. Income on Escrowed Funds. Early case law created the possibility of “homeless” income on escrows in which no one pays current tax. IRS had adopted this position in Rev. Rul. 71-119, 1971-1 C.B. 163, *revoked*, Rev. Rul. 92-51, 1992-2 C.B. 102. Following the 1986 enactment of section 468B(g), escrow accounts could no longer generate this homeless income. Section 468B(g) states:

   Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

Implementing regulations could deal with this situation in any of several ways: For example, Seller could be treated as the grantor of a grantor trust (escrow funds treated as paid to the seller and then placed in escrow), or A could be the grantor (escrow funds treated as contingent payment like earn-out discussed above). In the absence of regulations under section 468B(g), buyers and sellers have often structured escrow arrangements by choosing which of them is treated as the grantor. Recently, however, regulations were proposed requiring that, only for purposes of taxing escrow income, escrowed purchase price is treated as belonging to A (the provider of the cash) until the rights to the funds are fully established. Proposed Reg. § 1.468B-8 (January 29, 1999).
B. If Escrow Is A’s Property.

1. **Treatment at Closing to Seller.** If the escrowed funds continue to belong to A, and if Seller reports the sale on the installment method, deferral is permitted until the escrow is resolved. If Seller elects out of the installment method, Seller would realize the fair market value of its contingent right to the escrowed funds in the year of the sale. Reg. § 1.1001-2(g)(ii). In other words, the escrow is treated in the same manner as contingent purchase price payments. See parts I.B. and I.C., above.

2. **Treatment at Closing to A.** The escrow is treated as a contingent portion of the sale proceeds, A is not entitled to take the escrow into account because the amount of payment is not “fixed and determinable.” That is, A cannot include the escrowed funds in its basis in the assets purchased until it is determined that escrowed funds are to be paid to Seller.

3. **Income Earned on Escrowed Funds – Proposed Reg. § 1.468B-8.**

   a. **Treatment of “Contingent At-Closing Escrow” – “Determination Date.”** Under the proposed regulations, income earned on the escrowed funds is taxed to A as earned, regardless of whether Seller or A is treated as the owner of the escrowed funds for other purposes. Proposed Reg. § 1.468B-8(c) provides that income on escrowed funds in a “contingent at-closing escrow” is always taxed to A until the “determination date,” i.e., the date the last bona fide contingency involving payment of the escrowed funds is resolved. After the “determination date,” income is taxed to the owner of the funds based on the determination.

   b. **Scope of Proposed Regulations.** The treatment of income earned by escrows is the only issue resolved in the proposed regulations. Otherwise, the proposed regulations disclaim resolving ownership of the escrowed funds for other purposes, such as the consequences of distributions from escrow, e.g., the character of the distribution as interest or principal. Proposed Reg. § 1.468B-8(d).

   c. **“Contingent At-Closing Escrow” Defined.** A “contingent at-closing escrow” is an escrow or similar fund established at the closing of a sale or exchange of trade or business or investment property (but not a tax-free reorganization or a deferred section 1031 exchange, see part VII., below) to await resolution of contingencies that will determine whether A or Seller is entitled to the escrowed funds. Until all these issues are resolved, the income continues to be taxed to A, even if it has been resolved that some of the escrowed funds will be distributed to Seller. To fine tune this rule, consider using more than one escrow fund, so that each determination can affect an entire fund.

   d. **Anomaly.** Under Proposed Reg. § 1.468B-8, the income on a “contingent at-closing escrow” is taxed to A, even if the escrow is treated as belonging to Seller for other purposes. In this type of situation, it is not clear how the amount realized to Seller and the asset basis to A are computed. Suppose, for example, that an
escrow of purchase price is treated as belonging to Seller at closing (e.g., an escrow to secure Seller’s indemnity obligation). That is, at closing the underlying property in escrow is included in Seller’s amount realized. Suppose further that the income on the escrow is distributed to Seller periodically as earned. Still, under Proposed Reg. § 1.468B-8, the income will be taxed to A. Does the distribution of the income to Seller count as additional purchase price, taxed again to Seller? Or, does the limited scope provision in Proposed Reg. § 1.468B-8(d) mean that this income and distribution is simply ignored for purposes of amount realized and basis? If so, A will be taxed on income it never receives, and Seller will receive cash on which it never will be taxed. In light of this problem, Treasury and IRS should re-consider the approach to this income. In the meantime, A and Seller should make efforts to avoid escrows of funds that belong to Seller for other purposes.

e. “Disputed Ownership Funds.” The proposed regulations contain separate rules for “disputed ownership funds,” which are escrows and similar funds under court jurisdiction pending resolution of a dispute. Proposed Reg. § 1.468B-9. Such a fund is taxed as a separate entity, generally as a “qualified settlement fund” (“QSF”), under Reg. § 1.468B-1. The proposed regulations also allow the grantor of a QSF to elect to have the income earned by the QSF taxed to the grantor instead of to the QSF as a separate entity. Thus, if A so elects, A will continue to be taxed on escrow income. The preamble to the proposed regulations requests comments as to a transition of funds from “contingent at-closing escrow” to “disputed ownership fund” status. See Rev. Rul. 87-127, 1987-2, C.B. 156 (income earned on amounts placed in pre-need funeral trust generally taxed to customer; but see Code § 685).

4. Treatment on Payment to Seller. Each payment to Seller from the escrow account is discounted from the date of sale subject to the imputed interest rules of sections 483 and 1274 (or a higher rate, if parties have so provided in the agreement). The interest portion is taxable to Seller and deductible to A. The principal portion of the escrowed funds does not, under the tax accounting rules, entitle A to basis adjustments in the purchased assets until it is determined that the escrowed funds are to be paid to Seller.

5. Treatment on Return of Escrowed Funds to A. The return is not treated as a reduction in the purchase price, because amounts were never considered to have been paid to Seller. Return of funds would be a return of A’s capital.

C. If Escrow Is Seller’s Property.

1. Treatment at Closing to Seller. The results do not depend on the contingent debt instrument rules, but rather on the section 1001(b) rules, because the escrow would be considered part of the sale proceeds. The full amount of the escrowed funds would be added to Seller’s amount realized. There would be no imputed interest because the amount is treated as if paid to Seller at the time of sale and transferred by Seller into
the escrow. Seller could not treat the escrow as an installment sale because the amount was considered paid to seller and so the escrow is not a debt instrument.

2. **Treatment of Escrow at Closing to A.** A should be allowed to include the escrowed payments in its asset basis, but there is no authority on point.

3. **Income Earned on Escrowed Funds.** Under Proposed Reg. § 1.468B-8(c), discussed in parts III.A.3. and III.B.3., above, the income earned on the escrowed funds still would be taxable to A until the “determination date.” Thus, Seller could be taxed in full on the escrowed funds at closing, while A is taxed on the income from those funds — a clearly inconsistent treatment. To avoid this complication, the parties should agree that the escrow funds belong to A until the determination date under the proposed regulations.

4. **Treatment on Payment to Seller.** No consequences because the amount would have been added to Seller’s sales proceeds at the date of the sale, except that earnings for the taxable year in which the escrow is resolved would be currently includible to Seller.

5. **Treatment on Return to A.** If escrowed funds are returned to A, this results in a reduction in the price A paid for the assets. Under principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the treatment to Seller would be a combination of an ordinary deduction (for the foregone interest) and capital loss (on the sale). *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo. 1977-429 (escrow payment to A from third party treated as reduction in purchase price when received). The treatment to A would be a reduction in the basis of the purchased property (except that the income already taxed to A would be return of capital).

D. **If Escrowed Property Is Stock of A or A’s Parent.**

1. **Taxable Gain to A.** Suppose A places its own stock in escrow in a taxable acquisition, and the stock appreciates while in escrow. Regardless of whether the stock is treated as owned by A or Seller, there should be no taxable gain to A, under section 1032. Suppose A is a subsidiary, and stock of A’s parent corporation is placed in an escrow. Does A recognize taxable gain if the escrowed stock is released to Seller later? Rev. Rul 74-503, 1974-2 C.B. 117. If A and its parent file consolidated returns, A would recognize no gain or loss on its use of its parent stock to acquire property, provided a series of tests are met. Reg. § 1.1502-13(f)(6)(ii). One of these tests is that the subsidiary must transfer the stock “immediately” and “pursuant to a plan” to an unrelated non-member. Under proposed regulations, a subsidiary (whether or not consolidated) would recognize no taxable gain or loss, provided it transfers the stock “immediately.” Proposed Reg. § 1.1032-3(c)(2). Based on the examples in the proposed regulations, “immediately” seems to mean that, in an escrow situation, A is not entitled to any reversionary interest in the parent stock. Escrow agreements involving parent stock should so provide.
2. **Tax on Dividends.** Suppose A places its own stock in escrow in a taxable acquisition. Under Proposed Reg. § 1.468B-8, any dividends paid on the escrowed stock would be considered to belong to A and presumably would be tax-free. Suppose A is a subsidiary, and stock of A’s parent is placed into an escrow. In this case, the dividend income presumably would be taxed to the subsidiary, subject to the dividends received deduction — possibly 100% under Code section 243(b). See part III.B.3.a., above.

**IV. Contingent Liabilities in Taxable Asset Acquisitions.**

A. **Introduction.** In asset acquisitions A may assume T obligations that are not fixed in amount or timing or as to which it is not clear whether they are owed at all. These types of contingent obligations include retirement pay, severance pay and other employee benefits, environmental cleanup costs, commercial or tort claims against T, tax deficiencies, etc.

B. **Whose Liability? Contingent Liability or Defect in Assets? What Is at Stake?**

1. **T’s or A’s Liability — Consequences.**

   a. **T’s Liabilities Assumed.** If A assumes T’s liabilities, the liabilities are treated as part of the purchase price for the T assets. T treats the expenditure as an increase in the purchase price, resulting in gain and possibly an offsetting deduction, and A capitalizes the expenditure in the basis of the purchased assets.

   b. **A’s Expenditures.** If an expenditure is considered A’s own expenditure, then it has no impact on T, and it is deductible or capitalized by A, as though there had been no acquisition.

   c. **Incentives to Seller, T and A.** It is generally advantageous to all parties to treat an expenditure by A as A’s expenditure, rather than as an assumption and payment by A of T’s liability. This is especially true if the expenditure results in an immediate deduction. Thus, it can be expected that the parties will use this treatment whenever possible.

2. **Alternative Analysis.** Can an obligation on A’s part to make payments in the future be viewed as something other than meeting its own obligations or assuming a T liability? Can it be viewed as an expenditure to improve or rehabilitate the assets purchased? If so, maybe T can be left out of the analysis, and A can deduct or capitalize the item under its normal accounting method.

3. **Authorities.** How can we tell the difference between A’s own expenditures and T’s liabilities assumed by A? In the compensation area, there are numerous authorities. Otherwise, it may be difficult to tell. The following factors may be relevant in determining whether an expenditure by A results from a liability assumed from T:
a. Pre-Sale Operations. Does the expenditure arise from T’s pre-sale operations or from post-acquisition events?

- Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973), cert. denied 415 U.S. 948 (1974), rehearing denied 416 U.S. 952 (1974). A bought T stock, and T was liquidated under old section 334(b)(2); litigation on cargo lost at sea was pending against T, but acquisition price was not reduced because of insurance and early success in litigation; A later paid to settle claim; payment capitalized in property acquired from T; fact that “liability was contingent and unliquidated . . . is of no significance.”


- Fisher Companies v. Commissioner, 84 T.C. 1319 (1985), aff’d without opinion 806 F.2d 263 (9th Cir. 1986). Amount realized on sale of building held increased by price reduction due to A’s assuming T’s obligation to lessee to repair roof.

b. Timing of Liability. Did legal liability for the item arise before or after the acquisition? If legal liability had arisen, was there substantial benefit to A in making the expenditure (other than the satisfaction of its liability)?

- Magruder v. Supplee, 316 U.S. 394 (1942). Assumed liability for real estate tax on purchased property added to basis (reversed by section 164(d)).

- Hamburger Co. v. Commissioner, 8 T.C.M. (CCH) 780 (1949). Payment of predecessor’s debt to improve successor’s credit rating deductible to successor.

- Rees Blow Pipe Manufacturing Co. v. Commissioner, 41 T.C. 598 (1964) (nonacq.), aff’d per curiam 342 F.2d 990 (9th Cir. 1965). T paid damages for concealing defects in property it transferred in exchange; capital loss under Arrowsmith v. Commissioner, 344 U.S. 6 (1952), corollary is adjustment to A’s purchase price.

- Hyde v. Commissioner, 64 T.C. 300 (1978). A purchased property in foreclosure subject to mortgage, then redeemed property; taxes and interest accruing after purchase deductible, pre-purchase taxes and interest capitalized; redemption fee deductible as interest.

- Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981). Obligation on nonrecourse note issued to oil well driller contingent on production held loan under “all events” test and not payment of deductible intangible drilling costs.

c. Surprise. Was A aware of the liability, or was it a surprise? Was the item reflected in the relevant financial statements (e.g., as a reserve)? Was it explicitly
reflected in the purchase price? Was it explicitly assumed in the acquisition documents?

- **Commissioner v. Oxford Paper Co.,** 194 F.2d 190 (2d Cir. 1952). A assumed obligation of lessee on lease, but lessee compensated A by transferring a building to it; even though A reported value of building as income when received, A’s depreciable cost basis in building held limited to allocable portion of contingent liability assumed, zero because of favorable lease terms.

- **Pacific Transport Co. v. Commissioner,** cited in part IV.B.3.a., above.


4. **Authorities on Employee/Retiree Compensation and Benefits.** A number of the authorities deal with compensation issues — pensions, vacation pay, settlement of employee stock options, retroactive wage increases. Generally, IRS and the courts have been sympathetic toward treating these items as A’s items, resulting in deductions to A.

a. **Pensions — Retired Employees.** Pensions for already-retired employees are treated as items assumed from T. F. & D. Rentals v. Commissioner, 365 F.2d 311 (7th Cir. 1966), aff’d 74 T.C. 335 (1965), cert. denied 385 U.S. 1004 (1967); David R. Webb Co. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983), aff’d 77 T.C. 1134 (1981); M. Buten & Sons, Inc. v. Commissioner, T.C. Memo 1972-44.

b. **Pensions — Employees Not Yet Retired.** Pensions for not-yet-retired employees are A’s items. M. Buten & Sons v. Commissioner, cited in part IV.B.4.a., above. Expenses undertaken to continue a pension plan (meeting minimum funding standards) are also A’s items. GCM 39274 (August 16, 1984). See also PLR 8411106 (December 16, 1983); TAM 8436002 (March 23, 1984).

c. **Retiree Medical Expense.** Often retiree medical plans are revocable at any time. If so, should the payments be treated as A’s items, because A makes the payments to improve worker morale and preserve the business? The forward look treatment of pension plan expenses in GCM 39274 would support this idea. See also H. Hamburger Company v. Commissioner, 8 T.C.M. (CCH) 780 (1949) (payment of predecessor debt to improve successor’s credit rating deductible to successor).

d. **Retroactive Pay Increase.** Retroactive pay increases are A’s items, if A finally agreed to them after the acquisition. Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963); United States v. Minneapolis & St. Louis Railway Co., 260 F.2d 663 (8th Cir. 1958).
5. **T Employee Stock Options, SARs and Severance Pay.** In this area, IRS has allowed T to deduct items that were paid by A in connection with, or even after, an acquisition of T by A. These authorities seem to require A to capitalize any payments it makes of this type.


- TAM 9540003 (June 30, 1995). T could deduct payments made to settle T employee stock options, even though payments were made by A.

- *Great Lakes Pipe Line Co. v. United States*, 352 F.Supp. 1159 (W. D. Mo. 1972). In connection with sale of assets and liquidation of T, T shareholders paid A cash to reimburse A for cost of obligation to T executives; payment held capital expenditure by T because obligation arose from asset sale.

- ISP Position Paper, Restricted Stock Purchase in Merger & Acquisition, 91 TNT 90-33 (April 23, 1991). T may deduct part of amounts paid to terminate restricted stock plan; amounts attributable to changes in plan made as part of acquisition plan must be capitalized.

- TAM 9125001 (December 24, 1991), modifying TAM 8741001 (June 16, 1987). See part IV.D.2.a., below.

- TAM 9438001 (April 21, 1994). T may deduct amounts paid by A to acquire T’s employee stock options, stock appreciation rights, etc.

- TAM 9540003 (June 30, 1995). In connection with tender offer by A for T stock, T made payments to cancel its stock options, stock appreciation rights; amounts paid reflected “premium” in T stock value from A’s offer; T may deduct all amounts paid, including premium.

- TAM 9721002 (January 24, 1997). Severance pay to T executives deductible to A, even though plan instituted by T in preparation for acquisition, because A, not T, decided to terminate executives. See also TAM 9731001 (January 31, 1997).

- TAM 199923045 (October 9, 1998). Employees were awarded cash performance units based on three years earnings per share, and they received the cash within 2-1/2 months of the fourth year. Awards were not “deferred compensation” and so were deductible in the third year under the “all events” and “economic performance” tests. Thus, if the performance units had vested at an acquisition date, T would be entitled to the deduction.

**C. Treatment if A’s Liability.** In this case, the treatment is relatively simple and generally favorable to the parties. Essentially, the treatment is the same as if there had been no acquisition.
1. Treatment at Closing and upon Payment by A.

   a. T’s Treatment. Because the payment is of A’s own liability, there is no impact on T.

   b. A’s Treatment. A deducts or capitalizes the payment as though there had been no acquisition.

2. Treatment of Indemnity Payment by T.


   b. A’s Treatment. Under Arrowsmith v. Commissioner, 344 U.S. 6 (1952), the indemnity payment could take on the same character as the item being indemnified. The result would be to eliminate the deduction, but this result is not consistent with the treatment of the payment as a purchase price reduction. The better treatment seems to be that the indemnity is a return of part of A’s purchase price for the assets, thus preserving A’s deduction. Central Gas & Electric Co. v. United States, 159 F.Supp. 353 (Ct. Cl. 1958).

D. Treatment If T’s Liabilities Assumed — Current Law. If T’s contingent liabilities are viewed as assumed by A, current law is clear that the assumption or payment is an adjustment to the purchase price for the T assets. Because there is no actual payment from A to T, this analysis is complicated for both parties. It also leads to a series of different treatments, depending on the type of contingent liability involved. The aspect to watch is how the item would have been treated if it stayed with T until it became fixed and was paid. For this purpose, we have the following categories:

- Non-deductible items (e.g., T’s federal income tax liability).
- Currently deductible items.
- Delayed deductible items (e.g., payments under sections 404(a)(5) and 461(h)).
- Capital items of T (e.g., assumption of T indemnity from T’s prior acquisition of asset purchased by A from T).

The common element is that A is viewed as though it had assumed the liability in lieu of paying cash to T for the assets.

1. Non-Deductible Items. As an example, A might have to pay an adjustment to T’s Federal income tax liability from a prior year and not be indemnified. Even here, the results are not clear. The usual analysis is that the tax payment is treated as an increase in the purchase price for the assets.
a. Consequences to T.

i. Expected Liability. If T knows about the tax problem at closing, T may have to adopt the installment method or, if not, to elect out and report the fair market value of P's assumption as gain at closing, although no interest is imputed. See parts I.B.1.a. (election out) and I.C.4.a. (installment method), above. In a section 338(h)(10) stock sale, there is an open transaction to T. See part II.A.2., above.

ii. Surprise Liability. If the tax problem comes as a surprise to T, T would recognize additional gain on the sale when the liability is paid — like any other open contingent purchase price, except there is no imputed interest or OID. See parts I.B.1.b. and I.B.3., above; Reg. § 1.1274-5. Does the delayed gain recognition mean that the installment sale rules apply at least in an asset sale, but not in a section 338(h)(10) stock sale? Not clear, but the exception to imputed interest on assumptions of contingent liabilities suggests that this is a separate regime.

b. Consequences to A. When the payment is made, A adds the amount paid to the purchase price of the T assets and begins to take depreciation deductions at that time. See part I.D.3., above, and Merkel v. Commissioner, 109 T.C. 463 (1997) (contingent liabilities not taken into account for purposes of section 108 insolvency exception, because taxpayer could not show that it was more likely than not that he would be called upon to pay them; court relied in part on GAAP treatment of contingent liabilities as support for this approach).

2. Currently Deductible Items. If an assumed liability is a currently deductible item (e.g., a deductible environmental or employee benefit expense), T and A both treat the item as an increase in the price paid for the assets.

a. Consequences to T. T has an increase in taxable gain. T should have an offsetting deduction as though it had paid the liability itself. TAM 9125001 (December 24, 1990), modifying TAM 8741001 (June 16, 1987). There, before a stock sale with a section 338(g) election, Old T had accrued vacation pay and warranty expenses, and New T assumed these liabilities. IRS added the assumed amounts to the purchase price in the deemed asset sale. In TAM 8741001 IRS denied Old T a deduction for the warranty expenses, because the claims were contingent, and Old T disappeared before the deductions could be claimed. IRS allowed the deduction for the fixed vacation pay liability. In TAM 9125001, however, IRS modified TAM 8741001 and allowed the deduction to Old T for the contingent liabilities at the same time as the item is taken into account to increase purchase price in deemed asset sale. See Reg. § 1.461-4(d)(5) (economic performance on liabilities assumed in business acquisition satisfied when amount is included in T's selling price).
b. **Consequences to A.** A begins depreciation when the liability is accrued. See part IV.D.1.b., above.

c. **Character of Payments.** There is no interest imputed. Reg. § 1.1274-5(a). Thus, as compared with a contingent purchase price, there is an artificial deferral of deductions to A, and to T there is a conversion of ordinary interest income into sale income (possibly capital gain).

3. **Delayed Deductible Items.** The common situation is that the liability is deductible but with restrictions as to timing. As examples, section 461(h) requires economic performance before any deduction to an accrual method taxpayer, and section 404(a)(5) delays a deduction for deferred compensation paid by an accrual method taxpayer at least until the employee reports the income.

   a. **Section 461(h) — T.** The section 461(h) regulations provide that, for T, economic performance occurs when there is an express assumption of a business liability in a purchase of a business, when T includes the assumption in its amount realized. Reg. § 1.461-4(d)(5). So T gets its deduction on these items when the liability becomes fixed, even if not yet paid by A.

   b. **Section 461(h) — A.** A begins its depreciation on the purchase price adjustment only when it pays the contingent item. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2)(i).

   c. **Section 404(a)(5) — T.** T may have an increase in the amount realized at closing (if the fair market value of the payment can be determined). See part IV.D.2.a., above. T may be entitled to a deduction for the deferred compensation, however, only when the employee is paid and so includes the payment in his or her income. TAM 8939002 (June 15, 1989). Reg. § 1.461-4(d)(5), which was published after the issuance of TAM 8939002, could be read, however, as allowing this deduction in any event when the amount is included in T's amount realized in the sale. Cf. Reg. § 1.461-4(d)(2)(ii)(A) (deduction postponed but only to extent not otherwise provided in Code or regulations). Section 338(h)(10) stock sales, however, involve open transaction treatment to Old T until the liability becomes fixed. See part II.A.2., above, and TAM 199923045 (October 9, 1998), discussed in part IV.B.5., above.

   d. **Section 404(a)(5) — A.** If A assumes a deferred compensation liability, A gets its depreciation deduction beginning only upon payment to the employee or perhaps when T includes the liability in its amount realized. See part IV.D.3.c., above.

4. **Capital Items of T.** An example of this situation would occur if A assumes T's obligation to pay a contingent purchase price or indemnity payments on a prior acquisition by T. Presumably, T would capitalize the payment in its purchase price, and T would increase its sale price in both acquisitions.
5. **Treatment of Indemnity by T.** An indemnity payment by T to A could be viewed in either of two ways:

a. An offset that negates assumption of the contingent liability, so that we pretend the assumption was never there, to extent of the indemnity. This treatment would be consistent with Rev. Rul. 79-278, 1979-2 C.B. 302.

b. A separate Class III asset sold by T to A — like a note issued by T to A. The separate asset would have allocated to it a part of the purchase price paid by A, including assumption of the contingent liability itself.

E. **Treatment If T’s Liabilities Assumed — Pierce Analysis.** At closing, T may be viewed as having paid A to assume its liability, in the form of reduced purchase price.

1. **Prior Use.** This approach was used in the context of an asset sale under pre-1986 section 337. In such a situation, the deemed increase in sale price was tax-free to T (but only because of section 337). It also caused A to realize taxable income as a result of purchasing a business. *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964); Rev. Rul. 68-112, 1968-1 C.B. 62, amplified by Rev. Rul. 71-450, 1971-2 C.B. 78 (where A assumed obligation to provide subscribed-for newspapers, A treated as paying higher purchase price and then having part of the price returned as compensation income).

2. **Current Consequences.** The Pierce analysis is extremely complex and, in the post-General Utilities world, would be unfavorable to both T and A.

   a. **Consequences to T.** T adds the fair market value of A’s liability assumption to its amount realized in the asset sale and is deemed to make an offsetting payment to A. The character of this deemed payment to T has not been explored, but it seems sensible that the character of the deemed payment should be the same as the character of an actual payment by T of the underlying obligation (as discussed in part IV.D., above):

      • If a payment by T of the underlying obligation would be non-deductible (as discussed in part IV.D.1., above), the deemed payment to A also should be non-deductible to T.

      • If a payment by T of the underlying obligation would be deductible currently (as discussed in part IV.D.2., above), the deemed payment to A also should be deductible at the time the acquisition closes. See Reg. § 1.461-4(d)(5).

      • If a payment by T of the underlying obligation would be deductible on a delayed basis (as discussed in part IV.D.3., above), the deemed payment to A should be deductible on the same delayed basis.

      • If a payment by T of the underlying obligation would be a capital item (as discussed in part IV.D.4., above), the deemed payment to A should be
treated as part of the same of the capital asset involved, *i.e.*, a reduction in the amount realized (or an increase in the basis) of the asset.

**b. Consequences to A.** To A, the payment deemed received from T for assumption of the T liability has two consequences:

- A increases its purchase price for the assets. A should be able to depreciate the assets taking this amount into account immediately, even though the liability is contingent (*see* part IV.D., above), because A is considered to have paid this extra amount which is then returned to it.

- A has taxable income for the payment it is deemed to receive at closing. Then, when the liability is paid or accrued, A should have a loss on the separate transaction in which A was paid in taxable income to assume this obligation. This payment should not be added to A's basis in the assets acquired from T.

3. **Limits on Use of the Pierce Analysis.** The *Pierce* analysis has not been applied outside the publishing industry to account for prepaid subscription income that is allowed tax deferral. TAM 9823002 (February 5, 1998) (subscription income deferred by partnership under section 455 treated as partnership "liability" that increases basis in partnership interests). A more sensible result would be to adopt the *Pierce* treatment for T but to grant T a basis stepup with no income and no offsetting deduction.

**F. Treatment If T's Liabilities Assumed — Alternative Analyses.** The current law, especially the *Pierce* analysis, is very difficult, and it is tempting to come up with a simpler scheme.


   a. This system would have the great advantage of keeping T out of the matter. T may not be able to find out about the contingent liabilities that become fixed after the closing, at least if there is no indemnity.

   b. As an economic matter, it also makes some sense. It treats a contingent liability as different from a fixed liability or contingent purchase price and as more like an unfavorable business arrangement (*e.g.*, an above-market lease for the lessee) that reduces the value of the business itself. *See* section 1274(c)(4) (no imputed interest on purchase of assets subject to favorable or unfavorable financing).
c. In fact, this is probably what many parties actually do, and IRS seems not to have been active in challenging this result.

2. **Surprise Expenses.** Others have suggested allowing this result when the contingent liability is a surprise and is not reflected in purchase price. P. Canellos, “Reasonable Expectations and the Taxation of Contingencies,” 50 Tax Lawyer 299 (1997).

3. **Discounted Deduction.** Still others have argued that a step-into-the-shoes approach allows A the benefit of deductions sooner than is appropriate (because A would get an immediate full deduction, not depreciation). As a result, they suggest a discounted deduction for buyer. C. Crane, “Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer’s Deduction Really Costless?” 48 Tax Notes 225 (July 9, 1990); D. Halperin, “Assumption of Contingent Liabilities on Sale of a Business,” 2 Fla. Tax Rev. 673 (1996).

4. **Possible IRS Guidance.** This issue was in the Treasury-IRS Business Plan for 1995, but it was deleted from the 1996 Business Plan, and it has not been in a Business Plan since that time. It appears that substantial guidance on this issue is not likely to be issued soon.

V. **Taxable Stock Acquisitions.**

A. **Contingent Liabilities in General.** If A buys the stock of T, T’s treatment of its liabilities ordinarily does not change. T continues to deduct or capitalize its expenditures, without regard to the acquisition.

B. **Contingent Liabilities as Built-in Loss.**

1. **Section 382(h).** T’s contingent liability could be an unrealized built-in loss under section 382(h). If so, and if T has a net unrealized built-in loss, a section 382 limitation could apply to the deduction when the contingencies become fixed and the liability results in a deduction. It is not clear whether normal contingent liabilities will be treated as built-in loss items for this purpose. Code section 382(h)(6)(B).

2. **Consolidated Return Matters.** If S or A files consolidated return, other issues arise.

   a. **Loss Disallowance Rule Applied to S.** A contingent liability will reduce the value of the T stock purchased but will not reduce the basis of T assets. Nor will it count as a T “liability” under the loss disallowance rule. Reg. § 1.1502-20(c)(2)(vi). Thus, it could result in a “duplicated loss,” so that, if A sells the T stock at a loss, the loss may be disallowed, even though the contingent liability was reflected in A’s purchase price for the T stock.

   b. **Separate Return Limitation Year Rules Applied to T.** If the contingent liability is a built-in loss item under section 382(h), it may also be subject to a separate return limitation year (SRLY) limitation. But recent regulations generally prevent
section 382 and SRLY from applying to the same transaction. Reg. § 1.1502-15(g) (June 18, 1999).

C. Negative Investment Adjustments to A for Contingent Liabilities. If the liabilities result in deductions (directly or through amortization) when fixed or paid, A's basis in the T stock will be reduced under the investment adjustment rules. Reg. § 1.1502-32.

D. Indemnity by S for T's Contingent Liabilities.

1. General. If S retains a contingent liability of T, e.g., by agreeing to indemnify T or A, the case law and IRS view a payment of this indemnity as a contribution to T's capital by S, relating back to immediately before the stock sale, followed by a payment of the liability by T. This is the same analysis as is used in tax-free reorganizations. See part IX.B.4., below. The IRS Field Service Division has recently re-affirmed this analysis as the IRS position. FSA 199942025 (July 27, 1999).

2. Treatment of S. The indemnity payment is treated as an increase in S's basis in the T stock immediately before the stock sale. Bonham v. Commissioner, 89 F.2d 725 (8th Cir. 1937); Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976), aff'd on other grounds 558 F.2d 128 (2d Cir. 1977). To S it usually does not matter whether the payment is an increase in its basis in the T stock (capital contribution) or a reduction in its sale price for the T stock. In either case, under Arrowsmith the result is a capital loss at the time the indemnity is paid or becomes fixed. This capital loss may be deductible or may be disallowed under Reg. § 1.1502-20. See part V.B.2.a., above.

3. Treatment of A and T.

a. Indemnity of T Liability Paid by S or T. To A and T, it does matter whether an indemnity payment is a reduction in the purchase price paid by A or a capital contribution by S to T. If the payments are treated as purchase price adjustments, it is not clear whether T obtains any deduction (or asset basis) when S pays the indemnity and makes good T's loss on paying the liability. See Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946). If the indemnity is treated as a capital contribution, however, then presumably the payment of the liability itself is considered as made by T, and T is entitled to its deduction or basis stepup. The best facts would exist where S's indemnity obligation is owed to T (not to A); S makes the payment to T; and T pays the underlying liability. These niceties may not have to be observed, however. In Leward Cotton Mills v. Commissioner, 245 F.2d 314 (4th Cir. 1957), T paid T's pre-sale tax and interest under an indemnity agreement, and the court imputed a capital contribution and payment by T. A more basic question is whether the tax benefit rule will prevent T from claiming a deduction where it is reimbursed for the expenses. In VCA Corp. v. United States, 77-2 USTC ¶¶ 9554, 9736, 40 AFTR 2d ¶ 77-5429, unpublished opinion noted 566 F.2d 1192 (Ct. Cl. 1977), a reorganization case, the court rejected the IRS position and allowed the deduction.
IRS has since agreed with this conclusion. Rev. Rul. 83-73, 1983-1 C.B. 84. In GCM 38977 (April 8, 1982), IRS concluded that the same treatment would apply to a taxable stock purchase, and this view has been followed in two private rulings and in a recent field service advice. PLR 8429014 (April 16, 1984); PLR 9029058 (April 25, 1990); FSA 199942025 (July 27, 1999). By contrast, when A reimburses S for the tax benefit of indemnified payments, IRS has treated the reimbursement as an increase in the purchase price for the stock.

b. Settlement on Indemnity Obligation. Suppose S agrees to indemnify A for a T liability, and later S makes a payment to A to settle its obligation. Suppose also that, ultimately, T’s liability does not have to be paid at all or is paid in an amount less than S’s settlement payment. In other words, A keeps the payment from T. Should this payment still be included as a capital contribution by A to T, relating back to the sale (with, presumably, a deemed section 301 distribution by T to A)? Or is there a reduction in purchase price of the T stock? This question has not been resolved.

E. Other Indemnities by S to T or A. S may indemnify A for other risks — not T’s liabilities. For example, in *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo. 1977-429, a broker indemnified A for the inability to sell a T asset unwanted by A. The court treated the indemnity payment as a reduction in A’s purchase price for the T stock. The fact that a third party made the payment means that S’s treatment was not affected, but A’s basis in the T stock was reduced. There was no taxable income to T.

**TAX-FREE ACQUISITIONS**

VI. Contingent and Escrowed Stock in General.

A. Background. The tests for tax-free treatment of contingent and escrowed stock in tax-free reorganizations were developed in *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960), and *Hamrick v. Commissioner*, 43 T.C. 21 (1964) (acq. in result only). In these cases, IRS argued that contingent and escrowed stock arrangements did not constitute “stock” that could be received tax-free. The courts, however, rejected this argument. In response, IRS first ruled that contingent stock could be tax-free, but only if the right to receive the stock was not separately transferable. Rev. Rul. 57-586, C.B. 1957-2, 249; Rev. Rul. 66-112, 1966-1 C.B. 68; Rev. Rul. 67-90, 1967-1 C.B. 79.

B. Advance Ruling Guidelines. Ultimately, IRS developed advance ruling guidelines in Sections 3.03 and 3.06 of Rev. Proc. 77-37, 1977-2 C.B. 568, and then revised them in Rev. Proc. 84-42, 1984-1 C.B. 521. The tests relate to the following factors:

1. Business purpose for the arrangement (usually that the parties cannot agree on a price).
2. Time limit of 5 years until all stock is returned or issued.
3. Cap on amount of contingent or escrowed stock, no more than 50% of all the stock issued.
4. Rights to contingent stock not assignable, or at least not negotiable or readily marketable.

5. Only additional stock may be issued.

6. Contingencies are subject to objective determination; contingencies are not the control of the parties or contingencies relating to death or continued employment of a shareholder or to T's tax liability.

7. Any escrowed stock is issued and outstanding, and T shareholders are entitled to vote the stock and receive dividends; contingent stock is not issued and outstanding and involves no dividends or voting rights.

If these tests are met, contingent stock and escrowed stock each is treated as stock that qualifies for tax-free treatment, even though contingent stock may represent a promise to issue stock in the future. Thus, contingent stock and escrowed stock are tax-free when received and count favorably toward the continuity-of-interest test and the "solely for voting stock" test. An example of a private ruling using these tests is PLR 9827027 (April 3, 1998).


VII. Escrowed Stock.

A. Escrowed Stock as "Stock." If escrowed stock satisfies the tests in Rev. Proc. 84-42, it is treated as 'stock' qualifying for tax-free treatment. See part VI.B., above.

B. Treatment at Closing. In a reorganization, escrowed stock is treated as though A had issued the stock to the T shareholders, who then transferred the stock to the escrow. At least that is what IRS contemplates in Rev. Proc. 84-42. The T shareholders are to vote the stock. Dividends are "to be distributed" and taxed to the T shareholders. Can the dividends be escrowed? Because escrowed stock is considered to belong to the T shareholders, the stock is part of the reorganization price, and the escrowed shares take part of the overall substitute basis under section 358. There is no imputed interest. Rev. Rul. 70-120, 1970-1 C.B. 124. (Compare part VIII.C., below, as to imputed interest on contingent stock.) Note that this treatment is not consistent with the treatment of escrows in taxable acquisitions, as reflected in Proposed Reg. § 1.468B-8. See parts III.A. and III.B., above. These proposed regulations would not apply to tax-free acquisitions. Proposed Reg. § 1.468B-8(b)(1).
C. Effect of Return of Escrowed Stock to A.

1. Possible Analyses. If escrowed stock is returned to A, e.g., because of indemnity obligations, there may be either (a) an adjustment to the reorganization purchase price (as in a taxable acquisition) or (b) a separate redemption of the stock by A, treated as a sale or a dividend under section 302.

2. Returned Stock Valued at Closing. Generally, return of the escrowed stock is treated as an adjustment to the purchase price, if the returned stock is valued based on its value at the time of the original acquisition. Rev. Rul. 76-42, 1976-1 C.B. 102. In this case, the remaining shares take on the part of the substituted basis that had belonged to the escrowed shares, and there is no gain or loss to the former T shareholders.

3. Changes in Stock Value Taken into Account. If the formula for the number of shares returned takes into account changes in A stock value since the transaction, the return of the escrowed stock is a separate stock redemption by A. Rev. Rul. 78-376, 1978-2 C.B. 149. If the redemption is treated as a sale under section 302(a), the basis of the remaining, non-escrowed stock is unchanged, and the “redeeming” T shareholders recognize gain or loss based on the current value of the returned stock and its basis. If the redemption is treated as a dividend under section 302(d), the basis of the returned stock shifts to other A stock under Reg. § 1.302-2(c).

4. Continuity of Interest. Under the new continuity-of-interest regulations, A stock issued in a potential reorganization and then redeemed by A “in connection with” the reorganization counts against continuity. Reg. § 1.368-1(e). Does this rule apply to escrowed stock? The regulations do not cover this point. A National Office official has made the following observations:

   a. There is a good chance that escrowed stock will be treated as issued in the acquisition and so counted favorably for continuity purposes.

   b. There is a good argument that return of escrowed stock would be treated as a separate transaction, not “in connection with” the reorganization.

5. Type-B Reorganization. For an example of this approach, see Rev. Rul. 76-334, 1976-2 C.B. 108. There, after a type-B reorganization, escrowed stock was returned for cash equal to half the stock value. IRS said the cash was received in a separate redemption and did not bust the type-B reorganization.

VIII. Contingent Stock.

A. Contingent Stock as “Stock.” Contingent stock is treated as “stock” for reorganization purposes, so long as the advance ruling guidelines are met. See part VI.B., above.
B. Treatment at Closing. The regime is different for contingent stock than for escrowed stock. Here the stock is treated as issued only when the contingency disappears, and the stock is actually issued. IRS has been concerned about how to determine stock basis when the contingent stock is issued, but it is well settled now that basis is reallocated among all the shares issued in the reorganization. Recently, IRS ruled that, after an acquisition involving contingent stock (the “first acquisition”), an acquisition of the acquiring corporation would not adversely affect the tax-free treatment of the contingent stock in the first acquisition, even though stock of the second acquiring corporation was issued instead of the contingent stock. PLR 9838007 (June 16, 1998).

C. Treatment of Receipt by Former T Shareholders — Imputed Interest.


2. Cash Basis. The interest is taxed to the recipient of the stock when the stock is received, based on a discounting from the date of the reorganization to the date the stock is received. In other words, there is no accrual of OID in the meantime. Reg. § 1.483-4(b) Example (2).

3. No Deduction to A?

   a. The 1997 Act may have made contingent stock much less attractive relative to escrowed stock. New section 163(l) provides that the issuer may not deduct the imputed interest on contingent stock, because the debt instrument is payable in stock. If so, the interest is fully taxable to the former T shareholders but not deductible to A.

   b. There is an argument that a contingent payment obligation is not a debt instrument within the meaning of section 163(l). This argument is based on Reg. § 1.483-4(b) Example (2), which says that a contingent stock obligation is “not a debt instrument for federal income tax purposes,” so that there is no OID under section 1274, but instead interest is imputed on the cash basis under section 483.

   c. Taxing the former T shareholders on imputed interest while allowing no deduction to T would be manifestly unfair. The premise of using section 483 to
tax the shareholders is that they are owed a debt which happens to be payable in T stock. Using section 163(l) to deny the deduction to A seems premised on the idea that the debt is not really debt. Also, to deny the deduction would create a trap to using contingent stock instead of escrowed stock.

D. Treatment of Receipt of Contingent Stock by Former T Shareholders — Effect on Basis of A Stock. If contingent stock is issued, the former T shareholders adjust their basis in their A stock to allocate to the contingent shares an appropriate part of their substituted basis under section 358. Contingent shares received as imputed interest take full fair market value basis. It is not clear whether the former T shareholders may identify specific shares with specific basis, or whether they must allocate all the basis (including the fair market value basis resulting from imputed interest income) among all the shares received. See Reg. § 1.1012-1(c) (FIFO and identification rules for sales of separate blocks of stock). But see Rev. Rul. 55-355, 1955-1 C.B. 418 (average basis used for A stock received in tax-free reorganization in exchange for several blocks of T stock).

E. Effect of Non-Receipt by Former T Shareholders. If the former T shareholders do not receive the contingent stock, there is no effect on either A or the former T shareholders.

IX. T’s Contingent Liabilities.

A. Possible Effect of Assumption of T’s Contingent Liabilities on Tax-Free Reorganization Status — the “Acquiring Corporation.”

1. The “Acquiring Corporation.” Contingent liabilities are like any other liabilities for purposes of determining whether their assumption is taxable “boot.” Generally, only the “acquiring corporation” may assume liabilities tax-free. This term is defined in Reg. § 1.381(a)-1(b)(2). See Rev. Rul. 70-107, 1970-1 C.B. 78, Rev. Rul. 70-224, 1970-1 C.B. 79, and Rev. Rul. 73-257, 1973-2 C.B. 189 (in triangular acquisition, P may assume T liabilities if a merger, but not otherwise).

2. “Cause-to-Direct” Acquisitions. In Rev. Rul. 64-73, 1964-1 C.B. 142, IRS allowed the acquiring corporation to cause T assets to be transferred directly to a lower-tier subsidiary. It is understood that IRS has taken the position that, in such a transaction, the T liabilities may not be assumed by the lower-tier acquiror.

B. Deductions to A and Related Matters.

1. “Step-in-the-Shoes.” The treatment of contingent liabilities in tax-free acquisitions is now codified in section 381(c)(16) and the regulations. Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a). Generally, A steps into T’s shoes and may deduct otherwise-deductible payments assumed from T. Nondeductible obligations assumed from T would not be deductible. W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948) (tax liability assumed in tax-free merger capitalized when paid; post-merger interest deductible); Rev. Rul 73-146, 1973-1 C.B. 61.
2. Exception. The only exception is that, if the liability was reflected in determining the amount of stock issued in the reorganization, we revert to the general rule in section 381(c)(4). Thus, A steps into T's method of accounting.

3. Section 351 Exchanges. Section 381 does not apply to transfers of businesses under section 351. Without section 381, the corporate transferee could be under the case law which tended to treat liability assumptions as part of the cost of the property and so capitalized (not deducted by anyone) when paid. Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946). See also F. Tinker & Sons Co. v. Commissioner, 1 B.T.A. 799 (1925); Caldwell & Company v. Commissioner, 26 B.T.A. 790 (1932); aff'd per curiam 65 F.2d 1012 (2d Cir. 1933); Automatic Sprinkler Company of America v. Commissioner, 27 B.T.A. 160 (1932); F. S. Stimson Corp. v. Commissioner, 43 B.T.A. 303 (1938); Brown Fence & Wire Co. v. Commissioner, 46 B.T.A. 344 (1942); Portland Gasoline Company v. Commissioner, 181 F.2d 538 (5th Cir. 1950). If the transferor did not recognize gain in the transfer (as would be the case for an assumed liability, unless section 357(b) or section 357(c) applied), the transferee would get no asset basis for the payment either. In Rev. Rul. 95-74, 1995-2 C.B. 36, however, IRS ruled that contingent environmental liabilities of a transferor assumed in a section 351 transfer of business resulted in deductions to the transferee as the payments were made. This ad hoc “step into the shoes” treatment is predicated upon the assets transferred making up a business, with the liabilities being related to that business. See also FSA 199905008 (October 29, 1998), modified by FSA 199929015 (April 20, 1999) (no gain recognized on assumption of contingent liabilities in section 351 exchange, and stock basis not affected by contingent liabilities, but section 351 does not apply if there is no business purpose for the exchange).

4. Indemnities. Contingent liabilities paid by A and indemnified by former T shareholders could be treated as never paid by A, because of the indemnity (especially if the indemnity involves return of stock issued in the reorganization). Alternatively, the indemnity payment could be treated as contributed to T's capital by S. As a result, a deduction would be allowed to A.

a. Treatment of A and T. In VCA Corp. v. United States, 77-2 USTC ¶ 9736, 40 AFTR 2d ¶ 77-5429, unpublished opinion noted 566 F.2d 1192 (Ct Cl. 1977), the court allowed A to deduct T's expenses, even though indemnified by the former T shareholders. This seems to be the right answer, since someone ought to have a deduction. IRS has adopted the view of the VCA court. AOD 1981-115. In this case, A should realize no taxable income from the reimbursement. Rev. Rul. 83-73, 1983-1 C.B. 84, clarifying Rev. Rul. 58-374, 1958-2 C.B. 396. GCM 38977 (April 8, 1982) explains the result as following from the treatment of the indemnity payment as a contribution to T's capital, occurring immediately before the merger.

b. Treatment of S. Treating the indemnity payment as a capital contribution means that S is not entitled to a deduction or loss on making the payment. Instead, the
payment is treated as an increase in S’s basis in its A stock before the sale. The result is akin to a double deduction, in view of the deduction for the item itself that T is granted, as described in part IV.B.4.a., above. This increased stock basis should be reflected in S’s basis in the A stock received in the reorganization. 

*Kaufmann v. Commissioner*, 10 TCM (CCH) 790, PH TCM ¶ 51250 (1951); *McGlothlin Estate v. Commissioner*, 370 F.2d 729 (5th Cir. 1967), aff’g 44 T.C. 611 (1965); *Edwards v. United States*, 70-1 USTC ¶ 9188, 12,654, 25 AFTR 2d 526 (W.D.Pa. 1970); *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo. 1972-44.
CONTINGENT CONSIDERATION
AND CONTINGENT LIABILITIES
IN ACQUISITIONS

OUTLINE
ADDENDUM

PROPOSED REGULATIONS
UNDER SECTIONS 338 AND 1060

OCTOBER 1999

ROBERT H. WELLN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.

TABLE OF CONTENTS

II A. Contingent Purchase Price and Contingent Liabilities in Stock Acquisitions with Section 338(h)(10) Elections – Proposed Regulations ................................................................. 1

A. Introduction ........................................................................................................................................ 1

B. Treatment of Old T ............................................................................................................................ 2
   1. Installment Method Available ........................................................................................................ 2
   2. Election Out of Installment Method - Amount Realized at Closing ........................................... 3
   3. Allocation of Amounts Realized Among Assets Deemed Sold ................................................... 6
   4. Character of Amounts Realized ..................................................................................................... 6

C. Treatment of New T .......................................................................................................................... 7
   1. Allocation of Contingent Purchase Price and Contingent Liabilities Among Assets Deemed Purchased .................................................................................................................. 7
   2. Timing of Effects on Basis ............................................................................................................ 7
   3. Elimination of Phantom Income ................................................................................................... 8
   4. “Breaking the Link” Between ADSP and AGUB ......................................................................... 8

D. Reporting and Administrative Requirements .................................................................................. 9
   1. Form 8023 ........................................................................................................................................ 9
   2. Other Administrative Requirements ............................................................................................... 9
IIA. Contingent Purchase Price and Contingent Liabilities in Stock Acquisitions with Section 338(h)(10) Elections – Proposed Regulations.

A. Introduction.

Part II. of the Outline discusses the section 338(h)(10) regime under current regulations. As discussed in Part II., section 338(h)(10) allows certain stock sales to be treated as though the target company ("Old T") had sold its assets to a new company ("New T") and then liquidated. Most commentators have concluded that, in a section 338(h)(10) transaction, under current regulations (1) the installment method is not available, but (2) if any of the purchase price is contingent, open transaction treatment is allowed for Old T as well as being required for New T.

This Addendum discusses a revised section 338(h)(10) regime that would be adopted under recent proposed regulations. Notice of Proposed Rulemaking REG-107069-97, RIN 1545-AZ58, 64 Fed. Reg. 43461 (August 10, 1999). The proposed regulations would revise all the regulations under section 338 (other than those dealing with international matters and with asset and stock consistency) and section 1060.

The proposed regulations would become effective for qualified stock purchases and asset acquisitions after the date of publication of final regulations. Proposed Reg. §§ 1.338(i)-
IRS and Treasury representatives have stated that they intend to publish final regulations based on the proposed regulations no later than early 2000.

The preamble to the Notice of Proposed Rulemaking (the “Preamble”) states the major purposes of the proposed regulations. One of the most important purposes is to reorganize the rules and make them more user friendly. Substantially, the main theme of the proposed regulations is that, with specific exceptions, a section 338(h)(10) stock sale is treated as though the transactions deemed to occur (asset sale and distribution to the Old T shareholders) had actually occurred.

As applied to sales with contingent purchase price or contingent liabilities, the proposed regulations would adopt significant changes on the seller side: the installment method could be used, but open transaction treatment would be restricted to “rare and extraordinary cases,” as in actual asset sales. On the buyer side the proposed regulations would eliminate the phantom income that can result from the existing asset classification system by adding two new asset classes, but the rule allowing special allocation of contingent payments to the basis of intangible assets would be eliminated.

B. Treatment of Old T.

1. Installment Method Available. Under the proposed regulations, the installment method would be available in the deemed asset sale and the deemed liquidation of Old T. The overriding principle would be that the transaction is treated as though it were an actual asset sale and liquidation. Proposed Reg. § 1.338-1(a)(2). Old T may not assert any position inconsistent with this principle. Proposed Reg. § 1.338(h)(10)-1(d)(9).

a. A’s Installment Note. The proposed regulations would treat Old T as selling its assets to New T but would treat the installment note issued by the stock purchaser (A) as though it were an obligation of the deemed asset purchaser (New T). Proposed Reg. § 1.338(h)(10)-1(d)(8)(i). This treatment would eliminate the technical bar to the installment method under the current regulations (i.e., the fact that the note is issued by A, not by the deemed asset purchaser, New T).

b. Other Consideration Deemed Paid to Old T. All other consideration deemed received by Old T in the deemed asset sale is treated as paid in cash. This rule would apply, for example, if A does not purchase all the T stock. It would apply also to assumed liabilities of the T shareholders (but not to assumed liabilities of T itself). Proposed Reg. § 1.338(h)(10)-1(d)(8)(i).

c. Other Rules. The installment method would apply as in an actual asset sale. For example, the rules prohibiting borrowing in contemplation of the sale and the deferral charge under section 453A would apply. Preamble at 43471. See part I.C.3., above, discussing the harsh application of the deferral charge. Although not referred to in the proposed regulations or in the Preamble, the rule restricting

d. **Deemed Distribution of A’s Installment Note.** The proposed regulations would treat the installment note as distributed to the shareholders of Old T. If there is more than one Old T shareholder, the installment obligations would be treated as distributed to the shareholders in the same amount they actually receive in the stock sale. Proposed Reg. § 1.338(h)(10)-1(d)(8)(ii).

e. **Example in the Proposed Regulations.** The most important part of the proposed regulations relating to installment sales is Proposed Reg. § 1.338(h)(10)-1(e) Example 10. The example shows that, if some Old T shareholders receive cash and others receive installment notes, there would be some immediate gain recognition in the deemed asset sale, but installment sale treatment would remain in effect notwithstanding the deemed liquidation of Old T. The most important point illustrated by the example is that, even if a particular T shareholder receives only installment notes, he or she may recognize immediate gain if other shareholders receive cash or do not sell their stock.

f. **Treatment of Contingent Purchase Price and Contingent Liabilities.** Neither the substantive rules nor the example deal with contingent purchase price or contingent liabilities under the installment method. In an actual asset sale under the installment method, Old T would recognize gain as the contingent payments are received. See part I.C.4., above. If Old T is an S corporation, this gain would be passed through and would cause an adjustment in the basis of the Old T stock and in the gain recognized to the shareholders in the liquidation.

g. **Legislative Proposal.** Installment sale issues will become largely moot if the Administration proposal to repeal the installment method for accrual basis taxpayers is adopted. This proposal was included in the Taxpayer Relief and Refund Act of 1999, adopted by the House and the Senate but vetoed by the President. More recently, it has been included in a proposal to extend expiring provisions. See part I.D.7., above, and Section 1508 of H.R. 2488, 106th Cong., 2d Sess. (1999).

2. **Election Out of Installment Method.** As in an actual asset sale, the installment method would apply to any installment sale, unless Old T affirmatively elects out. Preamble at 43471; see parts I.C.2. and I.E.2., above. In light of the possibility that any sale with a contingent liability could be eligible for the installment method (see part I.C.1., above), election out should be standard procedure.

a. **Amount Realized at Closing and Gain or Loss – General Rule.** If it elects out of the installment method, Old T would report as amount realized at closing the fair market value of the contingent purchase price (as in an actual asset sale). Reg. §§ 1.1001-1(g)(2)(ii), 15a.453-1(d)(2)(iii). See part I.B.1.a., above. Although the proposed regulations do not explicitly so state, the Preamble describes this
proposed change in the regulations as "breaking the link" between deemed seller treatment (ADSP) and deemed purchaser treatment (AGUB). Preamble at 43468. See part II.C.4., below. In this case, Old T should be able to recover its full asset basis against the amount realized at closing. There is no requirement for Old T to determine the fair market value of New T's deemed assumption of Old T's contingent liabilities. These are taken into account later. See parts IIA.B.2.d. and IV.D., below.

b. **Amount Realized at Closing – Open Transactions.** In the "rare and extraordinary cases" where the contingent purchase price cannot be valued, Old T could still use open transaction treatment and so have amounts realized only upon receipt or accrual and recover its full basis in the assets as payments are received or accrued. See parts I.B.1.b. and I.B.3., above.

c. **Amount Realized Upon Receipt of Contingent Purchase Price.** A contingent purchase price obligation owed to Old T by New T is a separate financial instrument with a basis in the hands of Old T (or its shareholders after the deemed liquidation). Reg. § 1.1275-4(c)(3).

i. One way to analyze this situation is that, when contingent purchase price is accrued or paid, the principal amounts, discounted from the date of sale, are treated as proceeds from the payments on this instrument. Once all payments have been received (or sooner, once the basis in the debt instrument has been recovered), Old T would recognize gain or loss on this instrument. The balance of the payments would be includible as interest income to Old T at the AFR or at a higher agreed-upon rate. That is, the contingent purchase price payments do not result in adjustments to ADSP.

ii. An alternative analysis is to treat the contingent purchase price as an adjustment to the amounts received in the deemed asset sale (ADSP), with gain or loss on the deemed asset sale being adjusted for the difference between the fair market value of the contingent payment obligation and the amount received (adjusted for time value). Under this analysis, if contingent purchase price is taken into account before the end of New T's first taxable year, it relates back to the day after the acquisition date, for both ADSP and AGUB purposes. Proposed Reg. §§ 1.338-4(b)(2)(ii), 1.338-5(b)(2)(ii).

iii. The proposed regulations do not state which analysis will apply. The Preamble makes clear that, in stating that "general principles of tax law" apply in connection with contingent items (Proposed Reg. § 1.338-7(a)), the proposed regulations are intended to treat section 338(h)(10) stock sales like actual asset sales and to eliminate the special "fixed and determinable" rule in the current regulations (Reg. § 1.338(b)-3T(c)). Preamble at 43468. It seems reasonable that the financial instrument method (part IIA.B.2.c.i., above) would be used in a closed transaction, and that the ADSP adjustment method
d. Amount Realized Upon Fixing or Payment of T’s Contingent Liabilities.
Contingent liabilities deemed assumed by New T are taken into account when the liabilities become fixed (accrual method) or are paid (cash method). There is no requirement to determine fair market value of these items at closing. There is also no imputed interest or OID. See part IV.D.1.a.ii., below. This event may also result in an offsetting deduction to Old T. See part IIA.B.4.c., below. Thus, even in an otherwise closed transaction (see part IIA.B.2.c.i., above), the accrual or payment of contingent liabilities will result in ADSP adjustments (see parts IIA.B.2.c.ii., above, and IV.D., below). If a contingent liability is taken into account before the end of New T’s first taxable year, it relates back to the day after the acquisition date, for both ADSP and AGUB purposes. Proposed Reg. §§ 1.338-4(b)(2)(ii), 1.338-5(b)(2)(ii).

e. Taxation of Amounts Realized Upon Receipt of Contingent Purchase Price or Fixing or Payment of T’s Contingent Liabilities.

i. Background. Thus, the seller side of a section 338(h)(10) stock sale can experience post-closing gain, loss or deductions. In a closed transaction with contingent purchase price, Old T may receive amounts greater or less than the fair market value of the contingent purchase price debt instrument and will recognize gain or loss (as well as interest income) on the instrument. In a “rare and extraordinary” open transaction with contingent purchase price, Old T will recognize gain or recover basis (and, again, receive interest income) upon accrual or receipt of the contingent purchase price amounts. Where contingent liabilities later accrue or are paid, there will be additional amount realized on the deemed asset sale and perhaps deductions. If the seller of the T stock must return part of the sale price (e.g., for an indemnity), there will be a reduction in the ADSP.

ii. Taxation. These additional gain, loss, income and deduction items are all included in the concept of “deemed sale gain” discussed in part IIA.B.4.c., below. They would be taxed to Old T even if T itself has ceased to exist (and even though Old T usually will be deemed liquidated). The additional gain or loss would be accounted for by the Old T shareholders in the year in which the adjustment occurs. Proposed Reg. §§ 1.338-7(c)(1), (c)(3). Unlike the current regulations (which assume that Old T’s shareholders will pay this tax), the proposed regulations would, in effect, require the parties to allocate this tax liability between themselves. The general rule is that, for purposes of determining amount realized to Old T on the deemed asset sale and New T’s asset basis, the tax liability on the deemed asset sale is retained by Old T, unless the parties agree otherwise. Proposed Reg. § 1.338-4(d)(1); Preamble at 43468. In any event (other than tax on gain passed through to S corporation shareholders), New T would remain liable to IRS for all of T’s taxes,
including taxes resulting from the deemed asset sale. Proposed Reg. §§ 1.338-1(b)(3)(i), 1.338(b)(10)-1(d)(2). See part IIA.D.2., below. Thus A should be sure that the selling T shareholders indemnify it for Old T's tax liability from purchase price adjustments.

3. Allocation of Amounts Realized Among Assets Deemed Sold. Old T's amount realized on the deemed asset sale is the fixed portion of the purchase price, plus the fair market value of the contingent purchase price, allocated among all assets, tangible and intangible, under section 1060. The amount realized first is considered to have been paid for cash and cash equivalents (Class I), then actively-traded personal property (including all certificates of deposit and foreign currency) (Class II), then accounts receivable, mortgages and credit card receivables which arise in the ordinary course of business (Class III), then inventories (Class IV), then all other non-assigned assets (Class V), then intangibles other than goodwill (Class VI) and finally goodwill (Class VII). Proposed Reg. §§ 1.338-6(b), 1.1060-1(c)(2). Later adjustments in the purchase price would result in readjustments to this allocation. Proposed Reg. §§ 1.338-4(b)(2)(ii); 1.338-7(b). See part IIA.C.3., below.


a. Contingent Purchase Price. A contingent purchase price obligation would be treated as a separate contingent debt instrument owed by New T to Old T. Old T would determine the amount and timing of interest under the contingent debt obligation rules, discounting back to the date of sale. Reg. § 1.1275-4(c). This determination would be made when the principal component is includible in Old T's amount realized, i.e., in the year the amount is paid or the contingency becomes fixed, and the balance of the payment would be interest.

b. Contingent Liabilities - Gain. The proposed regulations avoid any specific rule for contingent liabilities but rather state that contingent liabilities are taken into account under general tax principles. Proposed Reg. §§ 1.338-4(d)(2) (ADSP); 1.338-5(e)(2) (AGUB). Under these principles, when contingent liabilities included in the asset sale price are accrued or paid, the amount is included in Old T's amount realized from the deemed asset sale. There is no imputed interest on these amounts. See part IV.D.1.a.ii., below.

c. Contingent Liabilities - Deductions. The proposed regulations would introduce a new, all-purpose term - “deemed sale gain” - to include all of Old T's tax consequences from a deemed asset sale. The Preamble comments on this term as follows:

The expanded definition of deemed sale gain, in conjunction with the rules in § 1.338-7(c) of the proposed regulations (§ 1.338(b)-3T(h) of the current regulations), provides a mechanism for [Old T]...to report items that are properly taken into account after the acquisition date. One such item would be the deduction of an assumed liability of [Old T] that it could not deduct under its method of accounting on or before the acquisition date.
Preamble at 43467. This passage seems to confirm the general treatment of offsetting amount realized and deduction when an otherwise-deductible or capitalized contingent liability becomes fixed or is paid. *See* parts IV.D.2. through IV.D.4., below.

C. **Treatment of New T.** From New T’s perspective, a deemed asset purchase involving contingent consideration (whether contingent purchase price or T’s contingent liabilities) is accorded open transaction treatment, as in an actual asset purchase. *See* part I.D., above. That is, New T gets no asset basis for the contingent purchase price or contingent liabilities until the amounts are accrued or paid. The proposed regulations would not change this treatment. They are intended, however, to make clear that any economic performance rules that would delay inclusion of these amounts in New T’s asset basis are not overridden. Preamble at 43465.

1. **Allocation of Contingent Purchase Price and Contingent Liabilities Among Assets Deemed Purchased.** The same rules would apply to section 338(h)(10) stock acquisitions as apply to actual asset acquisitions. *See* part I.D.1., above, and, for discussion of the new proposed asset classes, *see* parts IIA.B.3., above, and IIA.C.3., below.

2. **Timing of Effects on Basis.** The same rules would apply to section 338(h)(10) stock sales as to actual asset acquisitions. *See* part I.D.3., above.

a. **Upward Basis Adjustments.** New T would be entitled to make an upward basis adjustment upon accruing or making an additional purchase price payment to Old T or accruing or paying a contingent liability. Proposed Reg. §§ 1.338-7(b), (d).

b. **Recovery Methods and Periods.** New T would allocate each accrual or payment, as noted above, among the purchased assets, in the order described in Proposed Reg. § 1.338-6(b). *See* parts IIA.B.3., above, and IIA.C.3., below. New T would adjust basis in depreciable property and take depreciation deductions proportionately over the remaining life of the assets. If the asset has been disposed of or fully depreciated at the time the adjustment is made, the proposed regulations refer to general principles of tax law. Proposed Reg. §§ 1.338-7(c)(3). Presumably, under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952), New T would realize gain or loss in this situation.

c. **Recovery Methods and Periods — Intangible Assets.** New T may be able to argue that to the extent contingent payments are deductible, section 197 does not mandate 15-year recovery. Under *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), New T may be able to deduct contingent payments pertaining to specific intangibles. But the proposed regulations under section 197 seem intended to eliminate this treatment. *See* part I.D.3.d., above.
**d. Elimination of Special Purchase Price Allocation.** As a simplification measure, the proposed regulations would eliminate the rule allowing contingent payments to be allocated to specific intangible assets. Reg. § 1.338(b)-3T(g). But IRS has requested comments on this point. Preamble at 43470.

3. **Elimination of Phantom Income.** An important buyer-side change in the proposed regulations would be the addition of separate asset classes for receivables (proposed new Class III) and inventories (proposed new Class IV). See part IIA.B.3.b., above. Adding these two new asset classes ahead of the “everything else” class (existing Class III, proposed new Class V) would mean that, in a bargain purchase, receivables and inventories would be more likely to attract basis equal to their full fair market value and not share basis with other assets. This change would prevent phantom income from being taxed when purchased receivables are collected and inventories sold. Preamble at 43469. Although this proposed change is not specifically related to contingent purchase price or contingent liabilities, it could be important in situations where indemnity payments by the seller to the buyer reduce purchase price. Some practitioners have expressed concern that the new asset classes are too narrow, and that the descriptions of these new classes is not clear enough. Note that the phantom income problem can still exist in section 338(h)(10) acquisitions of tiered target corporations. Preamble at 43473-74.

4. **“Breaking the Link” Between ADSP and AGUB.** Outside of the installment method, the proposed regulations would confine open transaction treatment for Old T to “rare and extraordinary” cases (see parts IIA.B.2.a. and b., above). On the New T side, however, the proposed regulations would preserve open transaction treatment. In most situations involving contingent purchase price, the results would be completely inconsistent treatment between Old T and New T.

   a. **Old T’s Treatment.** Old T would value New T’s contingent purchase price obligation and set up a debt instrument with a basis equal to this value. As payments accrue or are received, they would be treated as part interest (taxable) and part payments on this debt instrument (return of basis, gain or loss). There would be no adjustment to ADSP for these amounts.

   b. **New T’s Treatment.** New T would not value its contingent purchase price obligation or set up any debt instrument at closing. Its basis in the T assets would exclude the contingent obligation. As payments accrue or are received, they would be treated as part interest (deductible) and part payments for the assets (added to AGUB and asset basis).

This inconsistency of treatment is intentional, in the sense that IRS and Treasury determined that section 338(h)(10) stock sales should conform to existing law governing asset sales. Preamble at 43468. Taxpayers may be expected to engage in self-help to avoid this whipsaw. Steps may include (i) claiming open transaction treatment because the contingent purchase price obligation cannot be valued, (ii) claiming closed transaction treatment but using a low fair market value for the
contingent purchase price obligation, (iii) using escrows in lieu of contingent purchase price obligations (see part III., below), and (iv) casting contingent purchase price obligations as contingent liabilities of T.

D. Reporting and Administrative Requirements.

1. **Form 8023.** As under the current regulations, the section 338(h)(10) election would be made jointly by the A and S (or S’s group) by filing a completed Form 8023 by the 15th day of the 9th month beginning after the acquisition date. Proposed Reg. § 1.338(h)(10)-1(c)(2). A copy of the completed Form 8023 must be attached to Old T’s final return (or the return of the selling group for the year of the qualified stock purchase) and New T’s first return. In contrast to an actual sale of assets, no Form 8594 must be filed.

2. **Other Administrative Requirements.** Generally, for purposes other than computing “deemed sale gain” by Old T (see part IIA.B.4.c., above), asset basis and depreciation by New T, Old T and New T would be treated as the same corporation. Examples of this treatment include treatment under various employee benefit and employment tax rules, continuation of the same employer identification number and, most important, New T’s continuing liability for Old T’s taxes. Proposed Reg. §§ 1.338-1(b)(2), (b)(3).
# TABLE OF CONTENTS

## TAXABLE ACQUISITIONS

### TAXABLE ASSET AND STOCK ACQUISITIONS — CONTINGENT PURCHASE PRICE
- Code Provisions ................................................................. 1
- Legislative History .......................................................... 1
- Legislative Proposal ........................................................ 1
- Regulations, Temporary Regulations and Proposed Regulations ........ 2
- Court Decisions ............................................................... 3
- Revenue Rulings and Notice ................................................ 3
- General Counsel Memorandum, Private Letter Rulings and Technical Advice Memorandum .................................................. 4
- Published Articles and Bar Association Reports .......................... 4

### TAXABLE ASSET AND STOCK ACQUISITIONS — ESCROWS
- Code Provision ................................................................. 5
- Legislative History .......................................................... 5
- Proposed Regulations ........................................................ 5
- Court Decisions ............................................................... 5
- Revenue Rulings ............................................................... 6
- Private Letter Rulings and Technical Advice Memoranda ............... 6
- Published Article and Bar Association Reports .......................... 6

### TAXABLE ASSET ACQUISITIONS — CONTINGENT LIABILITIES
- Code Provisions ................................................................. 7
- Regulations, Temporary Regulations and Proposed Regulations ........ 7
- Court Decisions ............................................................... 8
- Revenue Rulings ............................................................... 10
- General Counsel Memorandum, Private Letter Rulings, Technical Advice Memoranda and Industry Specialization Program Position Paper .................................................. 10
Published Articles and Bar Association Reports ................................................................. 11

TAXABLE STOCK ACQUISITIONS — CONTINGENT LIABILITIES AND INDEMNITIES .......... 12
  Code Provisions .............................................................................................................. 12
  Regulations ..................................................................................................................... 12
  Court Decisions .............................................................................................................. 13
  General Counsel Memorandum, Private Letter Rulings and Field Service Advice ........ 13

TAX-FREE ACQUISITIONS ................................................................................................. 14

TAX-FREE ACQUISITIONS — CONTINGENT AND ESCROWED STOCK ..................... 14
  Code Provisions .............................................................................................................. 14
  Regulations ..................................................................................................................... 14
  Court Decisions .............................................................................................................. 14
  Revenue Rulings and Revenue Procedure ..................................................................... 14
  Private Letter Rulings .................................................................................................... 15
  Published Articles .......................................................................................................... 15

TAX-FREE ACQUISITIONS — CONTINGENT LIABILITIES .......................................... 15
  Code Provision ............................................................................................................... 15
  Regulations ..................................................................................................................... 15
  Court Decisions .............................................................................................................. 16
  Revenue Rulings ............................................................................................................ 17
  Action on Decision, General Counsel Memorandum, Private Letter Ruling, Technical
    Advice Memorandum and Field Service Advice ......................................................... 18
  Published Articles and Bar Association Reports ......................................................... 18
CONTINGENT CONSIDERATION
AND CONTINGENT LIABILITIES
IN ACQUISITIONS

REFERENCES

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ROBERT H. WELLEN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.

TAXABLE ACQUISITIONS

TAXABLE ASSET AND STOCK ACQUISITIONS — CONTINGENT PURCHASE PRICE

Code Provisions

- Section 338(h)(10) (deemed asset sale on certain sales of stock with election)
- Sections 453(f)(8), (j)(2) (treatment of contingent payments in installment sales)
- Section 468B(g) (regulation authority on taxation of income earned on amounts in escrow)
- Section 483(d)(4) (exception from OID and imputed interest requirements for transfers of patents)
- Section 1060(a) (allocation of consideration in sales of trade or business assets, for purposes of seller’s gain and loss recognition and buyer’s basis)
- Section 1253(d) (current deduction for certain payments for franchises, trademarks and trade names)
- Section 1275(d) (regulation authority for OID treatment of contingent debt instruments)

Legislative History


Legislative Proposal

- U.S. Treasury Department, General Explanations of Administration Revenue Proposals (February 1999), 146 (proposal to repeal installment method for accrual basis taxpayers)
- JCS, Description of Modified Chairman’s Mark Relating to Expiring Tax Provisions, JCX-73-99 (October 20, 1999)
Prop. Reg. § 1.197-2(b)(11) (licenses and other contracts for use of intangibles treated as section 197 intangibles amortizable over 15 years; see also Prop. Reg. § 1.197-2(b)(10)(ii), excluding section 1253(d) transactions from section 197)

Prop. Reg. § 1.197-2(f)(2) (contingent payments after closing depreciated over remainder of 15-year period)

Prop. Reg. § 1.197-2(f)(3)(i) (in license or other contract to use section 197 intangible (all amounts required to be paid depreciable over 15 years, even if otherwise deductible; see also Prop. Reg. § 1.197-2(b)(11))

Temp. Reg. § 1.338(b)-3T(b) (definition of “contingent amount”)

Temp. Reg. § 1.338(b)-3T(c) (contingent payments and contingent liabilities taken into account when they become “fixed and determinable,” by both deemed buyer and deemed seller under sections 338(g) and 338(h)(10), in determining AGUB and asset basis; reductions of consideration or liabilities taken into account when the reduction “occurs”)

Temp. Reg. § 1.338(b)-3T(d) (FMV limitation for allocations to asset classes determined on the acquisition date and not adjusted later)

Temp. Reg. § 1.338(b)-3T(e) (decreases in AGUB allocated to asset classes in reverse order)

Temp. Reg. § 1.338(b)-3T(g) (allocation of consideration to contingent income assets; see Associated Patentees)

Temp. Reg. § 1.338(b)-3T(h) (contingent payments and contingent liabilities under section 338(h)(10) (seller side))

Temp. Reg. § 1.338(b)-3T(j) Examples (3), (4) (contingent payment under section 338(g) and 338(h)(10), buyer side (AGUB))

Reg. § 1.338(h)(10)-1(e)(5) (as contingent purchase price payments are made in section 338(h)(10) stock sale, new T adds amount paid to asset basis and depreciates new basis proportionately over remaining depreciable life)

Reg. § 15a.453-1(c) (contingent payments under installment method)

Reg. § 15a.453-1(d)(2)(iii) (FMV of contingent payments included in amount realized if seller elects out of installment method)

Reg. § 1.483-4(a) (imputed interest on contingent payment obligations under section 483; interest computed as under Reg. § 1.1275-4)

Reg. § 1.1001-1(a) (amount realized on property sale includes FMV of property received; property received in sale considered to have no FMV “only in rare and extraordinary cases”)

Reg. § 1.1001-1(g)(2) (amount realized on property sale for contingent debt outside installment method includes FMV of contingent payments)

Reg. § 1.1012-1(g) (basis of property acquired for debt instrument does not include FMV of contingent payments until contingency is fixed)

Temp. Reg. § 1.1060-1T(f)(1) (increase or decrease in consideration taken into account by both buyer and seller “under applicable principles of tax law”)

Temp. Reg. § 1.1060-1T(f)(2) (FMV limitation for allocations to asset classes determined on acquisition date and not adjusted later)

Temp. Reg. § 1.1060-1T(f)(4) (allocation of consideration to contingent income assets; see Associated Patentees, below, and section 197 proposed regulations, above)

Reg. § 1.1274-2(g) (contingent payments not included in property basis until they become fixed)
Reg. § 1.1275-4(c) (contingent payment debt instruments and OID outside "noncontingent bond method")
Prop. Reg. § 1.7872-2(b)(1)(iii) (deposit, e.g., escrow, not treated as loan under below-market loan rules, if held in trust for transferor's benefit)

Court Decisions

*Burnet v. Logan*, 283 U.S. 404 (1931) (open transaction treatment of contingent payment in stock purchase; basis to be recovered fully before gain reported)
*Associated Patenees v. Commissioner*, 4 T.C. 979 (1945) (cost to purchase patent, based on percentage of income earned thereon, deductible as paid)
*Monaghan v. Commissioner*, 40 T.C. 680 (1963), acq. 1964-1 C.B. 6 (installment sale treatment of contingent purchase price for goodwill; cash payment allocated to other assets)
*Holden Fuel Oil Co. v. Commissioner*, T.C. Memo 1972-45, aff'd 479 F.2d 613 (6th Cir. 1973) (contingent payments to purchase customer list held deductible as made, under *Associated Patenees*)
*Spencer v. Commissioner*, 110 T.C. 62 (1998) (redetermination of property basis results in adjustments to depreciation deductions for remainder of property life; see cases cited therein)

Revenue Rulings and Notice

Rev. Rul. 68-13, 1968-1 C.B. 195 (see *Monaghan*, above)
Rev. Rul. 77-56, 1977-1 C.B. 135 (stock sold for cash and note but subject to purchase price offset for breach or representation or warranty; contingent indemnity obligation “does not make the original contract price indeterminable”; installment sale method available with total contract price disregarding indemnity)
Rev. Rul. 79-278, 1979-2 C.B. 302 (A bought T stock from S and sold it at short-term capital loss; S paid damages to T under court-ordered settlement for securities law violations; under *Arrowsmith*, payment is short-term capital gain to A, reported in year court approves settlement)
Rev. Rul. 87-63, 1987-2 C.B. 210 (payments under commodity trading franchise license agreement not subject to section 1253(d) but deductible upon economic performance)
Rev. Rul. 88-24, 1988-1 C.B. 306 (on sale of franchise business subject to rights of original franchisee, buyer may amortize amount allocable, under section 1060, to purchased franchise rights, as provided in section 1253(d), even though transaction is sale of a capital asset)
Notice 90-56, 1990-2 C.B. 344 (installment sale regulations to be revised to prevent inappropriate deferral of basis recovery)
General Counsel Memorandum, Private Letter Rulings and Technical Advice
Memorandum

GCM 37073 (March 31, 1977) and cases cited therein (escrow deposits for accrual method contractor not income if release of funds from escrow conditioned on performance of contract, but income if contractor has power of investment)

PLR 8537049 (June 17, 1985) (income projections used as alternative method to recover basis in installment sale)

PLR 8621023 (February 19, 1986) (income projections used as alternative method to recover basis in installment sale)

PLR 8629038 (April 18, 1986) and authorities cited (installment sale method permitted in sale of subsidiary stock; funds placed in escrow to protect buyer against subsidiary’s potential liability in pending lawsuit deferred)

PLR 8645029 (August 8, 1986) (similar to PLR 8629038)

PLR 9743034 (July 28, 1997) and PLR 9743035 (July 28, 1997), revoking PLR 9211029 (December 13, 1991) (CPA’s negligence caused fund not to qualify as RIC and increased fund’s tax liability; insurance carrier reimbursed fund for tax, penalties and interest; reimbursement taxable income to fund because payment of actual tax liability; would not be income if advice had caused fund to pay more than its actual tax liability)

TAM 9853002 (undated) (Installment seller paid deferral charge under section 453A based on sale price including maximum amount of contingent payments; later seller determined that full contingent amount would not be received and applied for refund of deferral charge based on alternative form of basis recovery under Reg. § 15A.453-1(c)(7); refund denied, because seller did not obtain an advance ruling from IRS to use alternative basis recovery, and regulation relates only to timing, not amount of gain; results of election out of installment method compared)

Published Articles and Bar Association Reports


NYSBA Tax Section, “Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed by Section 468B(g) of the Internal Revenue Code,” 92 Tax Notes Today 156-31 (July 31, 1992)


R. Wootton, “Mrs. Logan’s Ghost: The Open Transaction Doctrine Today,” 71 TAXES 725 (1993)
TAXABLE ASSET AND STOCK ACQUISITIONS — ESCROWS

Code Provision

Section 468B(g) (income earned on escrow accounts, etc., subject to current income tax; regulations to be prescribed providing for taxation as grantor trust or otherwise)

Legislative History


Proposed Regulations

Prop. Reg. §§ 1.468B-8 and 468B-9 and Preamble, Escrow Funds and Other Similar Funds, RIN 1545-AR82 (January 29, 1999)
Prop. Reg. § 1.1032-3 (parent stock used as consideration in taxable acquisition by subsidiary; no gain or loss to subsidiary, provided stock is used in acquisition “immediately” after being issued to subsidiary)

Court Decisions

Brown v. Commissioner, 10 B.T.A. 1036 (1928) (X, shareholder-employee of T, wishing to induce A to buy remaining T stock from estate, promised to pay A part of back salary T might pay to X; payment held not income to A, reduction in A’s purchase price for T stock)
North American Oil Consol. v. Burnet, 286 U.S. 417 (1932) (income earned on property held in receivership pending determination of owner; held, not taxable to accrual-basis owner taxable in year earned, but in year turned over)
Steckel Estate v. Commissioner, 253 F.2d 267 (6th Cir. 1958), aff’g per curiam, 26 T.C. 600 (1956) (payment for taxpayer’s stock held by court pending resolution of suit against taxpayer income in year of payment)
Commissioner v. Hansen, 360 U.S. 446 (1959) (automobile dealer reserve accounts that only could benefit dealer in one form or another; held, taxable to dealer when amounts credited to accounts)
Anderson v. Commissioner, 20 T.C.M. 697 (1961) (T recognizes no income when A places funds in escrow to against possible breach of warranty for undisclosed corporate liabilities)
Freedom Newspapers, Inc. v. Commissioner, T.C. Memo. 1977-429 (taxpayer bought four newspapers, including one it did not want; broker agreed either to find buyer for the unwanted newspaper or to pay a cash amount; no buyer was found, and cash payment made; unwanted newspaper was sold later; cash payment held reduction in purchase price for unwanted newspaper, not liquidated damages for failure to sell unwanted newspaper, thus reduced capital loss on sale of unwanted newspaper, not ordinary income to purchaser)
Johnson v. Commissioner, 108 T.C. 448 (1997) (automobile dealers sold multi-year service contracts and placed in escrow a portion of proceeds to fund obligations; held, dealers own accounts and must currently include investment income under section 468B(g))
Revenue Rulings

Rev. Rul. 77-294, 1977-2 C.B. 173 (escrow imposing substantial restriction on seller’s right to receive sales proceeds eligible for installment method)
Rev. Rul. 79-91, 1979-1 C.B. 179 (six-year payment schedule is not a substantial restriction; installment method reporting unavailable)
Rev. Rul. 87-127, 1987-2, C.B. 156 (income earned by pre-need funeral trust generally taxed to purchaser of pre-need funeral)

Private Letter Rulings and Technical Advice Memoranda

TAM 199901003 (September 22, 1998) (no taxable gain to subsidiaries on use of parent stock and warrants to make taxable acquisitions, where parent issued stock and warrants specifically for this purpose)
TAM 9822012 (February 5, 1998) (corporate partner granted nonqualified stock options and SARs on its own stock to employees of partnership; employees have taxable income, and partnership has deduction from exercise of options and SARs; apparently no gain recognized to partnership (citing Rev. Rul. 80-76))
TAM 9822002 (October 23, 1997) (corporate partner transferred its own stock to partnership which used stock to acquire property; gain recognized on stock to partnership but allocated under section 705(c) to corporate partner and tax-free under section 1032(a))
PLR 92430033 (July 24, 1992) (income on county-established escrow pending court decision on validity of imposition of use tax; held, taxable)
PLR 9228020 (April 10, 1992) (income on SEC-controlled escrow accounts; held, not taxable because accounts established before effective date of section 468B(g))

Published Article and Bar Association Reports

Report on the Taxation of Escrow Accounts, Committee on Personal Income Tax of the Bar of the City of New York, December 26, 1990 (90 TNT 264-43) (recommending rules under which buyer generally is taxable on income generated by escrow)
Proposal on the Taxation of Escrow and Settlement Funds under I.R.C. Section 468B(g), County of L.A. Bar Ass’n Section of Taxation, May 4, 1991 (91 TNT 127-63) (depositor taxed on income unless transfer meets economic performance, in which case fund taxed)
Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed by Section 468B(g) of the Internal Revenue Code, New York State Bar Association Tax Section, July 20, 1992 (92 TNT 156-31) (escrows generally should be treated as grantor trusts with buyer as grantor)
TAXABLE ASSET ACQUISITIONS — CONTINGENT LIABILITIES

Code Provisions

Section 338(h)(10) (deemed asset sale on certain sales of stock with election)
Section 404(a)(5) (deferred compensation deductible by employer when includible by employee; see section 83(h))
Section 455(a) (deferral of prepaid subscription income)
Section 456(a) (deferral of prepaid club dues)
Section 461(h) (economic performance required for certain accruals)
Section 1060(a) (allocation of consideration in sales of trade or business assets, for purposes of seller's gain and loss recognition and buyer's basis)
Section 1274(c)(4) (exception from imputed interest requirement for liability assumptions on property sales)

Regulations, Temporary Regulations and Proposed Regulations

Prop. Reg. § 1.168-2(d)(3)(i) (when basis of depreciable property redetermined by later events, depreciation on redetermined basis deducted over remaining property life)
Reg. § 1.338(b)-1(c)(1) (fixed liabilities included in buyer's asset basis)
Reg. § 1.338(b)-1(f)(2) (contingent liabilities not included in AGUB, under sections 338(g) and 338(h)(10) (buyer side))
Temp. Reg. § 1.338(b)-3T(b) (definition of "contingent amount")
Temp. Reg. § 1.338(b)-3T(c) (contingent payments and contingent liabilities taken into account when they become "fixed and determinable," by both deemed buyer and deemed seller under sections 338(g) and 338(h)(10), in determining AGUB and asset basis; reductions of consideration or liabilities taken into account when the reduction "occurs")
Temp. Reg. § 1.338(b)-3T(d) (FMV limitation for allocations to asset classes determined on the acquisition date and not adjusted later)
Temp. Reg. § 1.338(b)-3T(e) (decreases in AGUB allocated to asset classes in reverse order)
Temp. Reg. § 1.338(b)-3T(h) (contingent payments and contingent liabilities under section 338(h)(10) (seller side))
Temp. Reg. § 1.338(b)-3T(j) Example (1)(iv)-(vi) (contingent liabilities under section 338(g), buyer side (AGUB))
Reg. § 1.446-1(c)(1)(ii) (contingent liabilities not included in basis)
Reg. § 1.461-1(a)(2)(i) (economic performance required for inclusion in basis of purchased property)
Reg. §§ 1.461-1(a)(2)(iii)(D), 1.461-4(d)(2)(iii) (except as otherwise provided, economic performance of obligation to pay employee benefits incurred when deductible under special statutory rules, but treatment under section 83 reserved)
Reg. § 1.461-4(d)(5) (economic performance occurs when buyer of business expressly assumes seller's liability for an otherwise-incurred item, if amount is included in seller's amount realized)
Reg. § 1.461-4(g)(1)(ii)(C) (express assumption of liability by buyer of business treated as "payment" by seller of an otherwise-incurred item, if amount is included in seller's amount realized)
Reg. § 1.461-4(j) (reserved for treatment of contingent liabilities)
Reg. § 1.1001-2(a)(1) (general rule that amount realized on sale of property includes amount of liabilities from which seller is discharged)

Reg. § 1.1001-2(a)(3) (no amount realized for liability assumption, if liability not included in basis)

Temp. Reg. § 1.1060-1T(f)(1) (increase or decrease in consideration taken into account by both buyer and seller "under applicable principles of tax law")

Temp Reg. § 1.1060-1T(f)(2) (FMV limitation for allocations to asset classes determined on acquisition date and not adjusted later)

Reg. § 1.1274-5(a) (no imputed interest on assumed liabilities in asset sale)

Reg. § 1.1502-76(b)(4) Example (5) (if T leaves consolidated group, deduction for contribution to qualified retirement plan for year may be either claimed for year in which payment is made or allocated ratably between the two short years)

Court Decisions

_Cooleedge v. Commissioner_, 40 B.T.A. 1325 (1939) (acq.) (cash basis seller's amount realized on sale of real property held to include buyer's payment of accrued mortgage interest and taxes; seller entitled to deduct interest and taxes when paid)

_Magruder v. Supplee_, 316 U.S. 394 (1942) (assumed liability for real estate tax on purchased property added to basis; reversed by section 164(d))

_Commissioner v. Oxford Paper Co._, 194 F.2d 190 (2d Cir. 1952) (taxpayer assumed obligation of lessee on favorable lease, but lessee compensated taxpayer by transferring a building to it; even though taxpayer reported FMV of building as income when received, taxpayer's depreciable cost basis in building held limited to allocable portion of contingent liability assumed, zero because of favorable lease terms)

_Shannonhouse Estate v. Commissioner_, 21 T.C. 422 (1953) (S sold real property and 2 years later made expenditures to eliminate encroachment of building on adjoining lot and for related legal fees; expenditures held part of sale of property and capital loss under Arrowsmith)

_Central Elec. & Gas Co. v. United States_, 159 F. Supp. 353 (Ct. Cl. 1958) (after sale of stock and liquidation of target corporation, seller paid target's pre-sale tax deficiency and interest thereon directly to government; held, in making payment, seller acted as target's agent; payment was reduction to purchase price of stock and payment by target, so that buyer of target stock could deduct interest, but only interest that accrued after liquidation of target; prior interest was part of cost of target's assets acquired in liquidation)

_Albany Car Wheel Co., Inc. v. Commissioner_, 40 T.C. 831 (1963) (no step-up in cost basis of business assets for buyer's payment of severance pay to union employees, when buyer had negotiated new collective bargaining agreement relating to severance pay, and there was no liability at time of purchase)

_James M. Pierce Corp. v. Commissioner_, 326 F.2d 67 (8th Cir. 1964) (in sale of publication, seller's amount realized held to include reserve for unearned and previously-untaxed subscription payments; seller's continuing but contingent liability disregarded; but offsetting deduction allowed to seller for amount deemed paid to buyer to assume the liability; in dictum, court states that buyer may have taxable income on deemed payment; see Rev. Rul. 68-112)

_Rees Blow Pipe Manufacturing Co. v. Commissioner_, 41 T.C. 598 (1964) (nonacq., aff'd per curiam 342 F.2d 990 (9th Cir. 1965) (after taxpayer participated in tax-free exchange of
real property and sold property it received, taxpayer paid damages for concealing defects in property it transferred in exchange and related legal fees; citing *Arrowsmith*, payments held capital loss; court states that, if made before property was sold, payments might have been added to basis

*F. & D. Rentals v. Commissioner*, 365 F.2d 311 (7th Cir. 1966), aff'g 74 T.C. 335 (1965), cert. denied 385 U.S. 1004 (1967) (unfunded pension liability assumed by buyer of business but not timely paid; liability held not deductible or added to asset basis when assumed because contingent; *dictum* that payment would be deductible under section 404(a)(1) when made)

*Turco v. Commissioner*, 52 T.C. 631 (1968) (after taxpayers sold a facility previously leased to a third party, septic problems developed, and taxpayer-sellers paid to correct it; held, expenditure was associated with the sale under *Arrowsmith*, and was capital loss to seller)

*Great Lakes Pipe Line Co. v. United States*, 352 F.Supp. 1159 (W.D. Mo. 1972) (in connection with sale of assets and liquidation of T, T shareholders paid buyer cash to reimburse buyer for cost of obligation to T executives; payment held capital expenditure because arose from asset sale; buyer's treatment not discussed)

*Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974), reh 'g denied 416 U.S. 952 (1974) (P bought S stock, and S liquidated under old section 334(b)(2); litigation on cargo lost at sea pending against S, but acquisition price for S stock not reduced, because of insurance coverage and early success in litigation; P later made payment to settle claim; payment held not deductible but capitalized in cost of S property; fact that "liability was contingent and unliquidated . . . is of no significance")

*Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974) (taxpayer sold oil and gas leases; later discovered that wells illegally slanted; taxpayer paid financing bank to settle fraud claim; payment held capital loss under *Arrowsmith*; motivation for payment irrelevant)

*Hyde v. Commissioner*, 64 T.C. 300 (1978) (taxpayer acquired property by quitclaim, subject to mortgages in foreclosure proceedings, and then redeemed the property; taxes and interest accruing after quitclaim held deductible, pre-quitclaim taxes and interest capitalized; redemption fee deductible as interest)

*Gibson Products Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981) (obligation on nonrecourse note issued to oil well driller contingent on production held loan under "all events" test and not payment of deductible intangible drilling costs)

*Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981) (acq.) (cash basis seller of assets treated as paying payables assumed by buyer, because buyer assumed liabilities instead of paying more cash; buyer increases basis in assets by same amount)

*David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), aff'g 77 T.C. 1134 (1981) (buyer of T assets assumed and paid T's pension obligation to deceased T employee's widow; payments held not deductible, even if timely made, but added to T asset basis when made; M. Buten followed; *dictum* in *F. & D. Rentals* rejected)

*Fisher Companies v. Commissioner*, 84 T.C. 1319 (1985) aff'd without opinion 806 F.2d 263 (9th Cir. 1986), Issue 2 (amount realized on sale of building held increased by purchase price reduction due to purchaser's assuming seller's obligation to lessee to repair roof)

*Merkel v. Commissioner*, 109 T.C. 463 (1997) (contingent liabilities not taken into account under section 108 insolvency exception because taxpayer was not more likely than not to be called upon to pay them; court relies in part on GAAP treatment)
Revenue Rulings

Rev. Rul. 55-675, 1955-2 C.B. 567 (no gain to acquiror on acquisition of property and assumption of liabilities; acquiror’s basis excludes “contingent and indefinite” liabilities “until they become fixed and absolute and capable of determination with reasonable accuracy”; Oxford Paper distinguished based on contingency of liabilities here, but followed in finding no taxable income to buyer)

Rev. Rul. 68-112, 1968-1 C.B. 62, amplified Rev. Rul. 71-450, 1971-2 C.B. 78 (seller of newspaper paid buyer cash to assume prepaid subscription liability; payment deductible to seller and income to buyer; see James M. Pierce Corp.)

Rev. Rul 73-146, 1973-1 C.B. 61 (T could deduct amounts paid by it to employees to terminate nonqualified stock options, in connection with B reorganization)

Rev. Rul. 76-520, 1976-2 C.B. 42 (payment of costs to fulfill prepaid subscriptions assumed in section 334(b)(2) liquidation added to basis of acquired assets)

Rev. Rul. 77-56, 1977-1 C.B. 135 (stock sold for cash and note but subject to purchase price offset for breach or representation or warranty; contingent indemnity obligation “does not make the original contract price indeterminable”; installment sale method available with total contract price disregarding indemnity)

General Counsel Memorandum, Private Letter Rulings, Technical Advice Memoranda and Industry Specialization Program Position Paper

PLR 8128098 (April 17, 1981) (deferred compensation income to recipient and deductible to corporation when paid; no interest factor)

PLR 8411106 (December 16, 1983) (similar to GCM 39274)

TAM 8436002 (March 23, 1984) (similar to GCM 39274)

GCM 39274 (August 16, 1984) (payment of certain pre-acquisition pension liabilities assumed by purchaser of business capitalized (e.g., liability to PBGC for termination of plan and liability for unpaid benefits); but payments to meet minimum funding requirements to continue plan deductible as made, even if computed in part by reference to past service; David R. Webb Co. distinguished)

PLR 8612050 (December 23, 1985) (in stock sale with section 338(g) election, New T includes in income “imputed payment” by T to New T (reduction in purchase price) for New T to assume T’s liability for prepaid subscriptions and seminars (subject to deferral under section 455 and Rev. Proc. 71-21); T reports imputed payment as gain on deemed asset sale but deducts imputed payment; Pierce followed in context of section 338(g))

PLR 8749076 (September 11, 1987) (similar to PLR 8612050)

TAM 8939002 (June 15, 1989) (deduction allowed to seller for assumption of liability for accrued compensation; but, under section 404(a)(5), no deduction for assumption of liability for deferred compensation until income inclusion by employee; Commercial Security Bank distinguished because of section 404(a)(5); but see Reg. §§ 1.461-4(d)(2)(iii)(A) and 1.461-4(d)(5), adopted after issuance of this TAM)

TAM 9125001 (December 24, 1990), modifying TAM 8741001 (June 16, 1987) (before stock sale with section 338(g) election, T accrued vacation pay and warranty expense; liabilities assumed by New T added to purchase price in deemed asset sale; Old T allowed to deduct vacation pay on final return; IRS denied Old T deduction for warranty costs because
contingent; in modified TAM, deduction allowed to Old T when item is taken into account to increase purchase price in deemed asset sale.

ISP Position Paper, Restricted Stock Purchase in Merger & Acquisition, 91 TNT 90-33 (April 23, 1991) (T may deduct only part of amounts paid to terminate restricted stock plan; amounts attributable to changes in plan made as part of acquisition plan must be capitalized; see TAM 9721002)

TAM 9206004 (October 16, 1992) Issues 2 and 3 (after stock sale with section 338(g) election, New T made expenditures to cancel warrants issued to lenders and employee stock options; Commercial Security Bank followed: liability to make these payments added to purchase price in deemed asset sale; Old T allowed offsetting deductions (section 165(a) loss for warrants, section 162 deduction for employee stock options))

TAM 9438001 (April 21, 1994) (T may deduct amounts paid by P to acquire T’s employee stock options, SARs, etc.; P’s treatment not discussed)

TAM 9540003 (June 30, 1995) (in connection with successful tender offer by P for T stock, T made payments to cancel its stock options and stock appreciation rights; amounts paid reflected “premium” in T stock value from P’s offer; T may deduct all amounts paid, including “premium”)

TAM 9721002 (January 24, 1997) (severance payments made by New T after section 338(h)(10) stock purchase treated as payment of New T’s liabilities (not liabilities assumed from Old T) and currently deductible; IRS concluded that obligation was created after acquisition, because employees were terminated after acquisition)

TAM 9731001 (January 31, 1997) (similar to TAM 9721002)

TAM 9823002 (February 5, 1998) (prepaid subscription to partnership, deferred under section 455, treated as “liability” that increases basis in partnership interests)

TAM 199923045 (October 9, 1998) (Cash performance units were awarded to employees based on 3-year earnings per share and paid within 2-1/2 months after close of third year; payments are not “deferred compensation” under section 404(a)(5) and so may be deducted when services are performed. See Reg. § 1.461-4(d)(5))

Published Articles and Bar Association Reports


ABA Section of Taxation Legislative Recommendation 87-2, 1987-1 ABA Reports 105, 6

ABA Tax Section Newsletter 23, ABA Section of Taxation Policy 1950-1997, 17


P. Canellos, Letter to T. Wessel, Tax Notes Doc. No. 88-4629


C. Crane, “Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer’s Deduction Really Costless?” 48 Tax Notes 225 (July 9, 1990)
TAXABLE STOCK ACQUISITIONS — CONTINGENT LIABILITIES AND INDEMNITIES

Code Provisions

Section 382(h) (limitation on recognition of built-in losses)
Section 382(l)(1) (capital contributions not included in section 382 limitation)

Regulations

Reg. § 1.1502-15(g)
Court Decisions

**Bonham v. Commissioner**, 89 F.2d 725 (8th Cir. 1937) (in sale of target stock for cash and buyer stock, buyer stock deposited with buyer pending seller’s resolution of target’s contingent liabilities; held stock received by seller at closing and pledged back to buyer, and stock included in seller’s amount realized; court notes that, if buyer had retained the stock, it might have been contingent consideration with deferred tax)

**Duveen Brothers, Inc. v. Commissioner**, 17 T.C. 124 (1951), aff’d per curiam 197 F.2d 118 (2d Cir. 1952), cert. denied 344 U.S. 884 (1952) (taxpayer sold preferred stock and guaranteed buyers against loss from early redemption, when early redemption occurred, taxpayer made refunds; held, refunds were capital loss under *Arrowsmith*)

**Pierce v. Commissioner**, T.C. Memo. 1955-241 (seller of T stock indemnified buyer against T’s liability for tax and related interest; indemnity payment held partial refund of purchase price and capital loss to seller, not ordinary deduction)

**Leward Cotton Mills v. Commissioner**, 245 F.2d 314 (4th Cir. 1957), rev’g 26 T.C. 85 (1956) (shareholders of corporation whose stock was sold paid corporation’s pre-closing tax and interest thereon under indemnity agreement; held, payments made by shareholders became property of corporation, and interest was deductible to corporation, not just reduction to purchase price of stock)

**Nelson v. Commissioner**, T.C. Memo. 1971-327, aff’d per curiam 472 F.2d 1224 (9th Cir. 1973) (seller of loan company stock indemnified buyer against certain loan losses; indemnity payment held offset against sale proceeds and capital loss to seller under *Arrowsmith*, not ordinary deduction)

**Federal Bulk Carriers, Inc. v. Commissioner**, 66 T.C. 283 (1976), aff’d on other grounds 558 F.2d 128 (2d Cir. 1977) (on sale of target stock; new corporation formed by sellers through contribution of part of sale proceeds indemnified buyer because target were earnings less than projected; held, indemnity payment was reduction in purchase price for target stock and capital loss from sale of target stock under *Arrowsmith*, not ordinary loss, because no joint venture; most important factor was dedication of part of sale proceeds to indemnity; fact that buyer was taxed on income in Canada not dispositive)

General Counsel Memorandum, Private Letter Rulings and Field Service Advice

GCM 38977 (April 8, 1982) (Rev. Rul. 83-73 — see TAX-FREE ACQUISITIONS — CONTINGENT LIABILITIES, below)

PLR 8429014 (April 16, 1984) (payments by seller of target stock to target’s medical claims administrator after stock sale ruled capital contributions, not income to target, and deductible to target; payments by purchaser of target stock to seller for tax benefit of medical payments ruled adjustments to purchase price for target stock)

PLR 9029058 (April 25, 1990) (assumption by seller of target stock of target’s above-market lease obligation ruled contribution to capital, not income to target)

FSA 199942025 (July 27, 1999) (on sale of T stock, seller indemnified buyer against T’s environmental liabilities; T incurred liabilities, and buyer and seller settled indemnity claim; payments of environmental expenses deductible to T; indemnity payment treated as pre-sale capital contribution)
TAX-FREE ACQUISITIONS

TAX-FREE ACQUISITIONS — CONTINGENT AND ESCROWED STOCK

Code Provisions

Section 163(l) (no deduction for interest on debt instruments payable in issuer stock)
Section 483(f) (regulation authority on imputed interest for contingent payments)

Regulations

Reg. § 1.483-4(b) Example (2) (imputed interest but no OID on contingent stock issued in reorganization; right to receive contingent stock not a “debt instrument”)

Court Decisions

Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960) (contingent stock treated as “stock” for COI purposes)
Hamrick v. Commissioner, 43 T.C. 21 (1964) (acq. in result only) (same)
Fox v. United States, 510 F.2d 1330 (1974) (imputed interest required for contingent stock issued in reorganization)
Solomon v. Commissioner, 67 T.C. 379 (1976) (same)
Jeffers v. United States, 556 F.2d 986 (Ct. Cl. 1977) (same)
Catterall v. Commissioner, 68 T.C. 413 (1977) (same)
Cocker v. Commissioner, 68 T.C. 544 (1977) (same)
Katkin v. Commissioner, 570 F.2d 139 (6th Cir. 1978) (same)
Vorbleski v. Commissioner, 589 F.2d 123 (3d Cir. 1978) (same)
Kingsley v. Commissioner, 662 F.2d 539 (9th Cir. 1981) (same)
Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1987) (same)

Revenue Rulings and Revenue Procedure

Rev. Rul. 57-586, C.B. 1957-2, 249 (certificates of contingent interests in sock of P received by T shareholders in merger of T into P treated as boot, not stock, because transferable; Carlberg not followed)
Rev. Rul. 66-112, 1966-1 C.B. 68 (contingent right to receive additional P voting stock based on T’s future earnings not treated as boot and not inconsistent with B reorganization, because non-assignable; Hamrick followed; interest on delayed receipt of stock subject to interest imputation under section 483)
Rev. Rul. 67-90, 1967-1 C.B. 79 (same as Rev. Rul. 66-112, where number of additional shares contingent on future FMV of P stock)
Rev. Rul. 70-120, 1970-1 C.B. 124 (no imputed interest on escrowed stock in reorganization, if T shareholders vote and receive dividends)
Rev. Rul. 72-32, 1972-1 C.B. 48 (interest accrues on contingent stock based on earn-out in reorganization; interest deductible when obligation to issue contingent stock becomes fixed)


Rev. Rul. 76-42, 1976-1 C.B. 102 (return of escrowed stock issued in B reorganization, based on FMV of stock at time of reorganization, treated as adjustment of acquisition price; no gain or loss to shareholder)

Rev. Rul. 76-334, 1976-2 C.B. 108 (escrowed stock in C reorganization returned in settlement of dispute for cash equal to half of stock value; cash payment viewed as separate redemption of stock in value equal to cash; "solely for voting stock" test not violated; remaining stock returned, based on FMV of stock at time of reorganization; treated as adjustment to acquisition price, and no gain or loss to shareholder on stock returned)


Rev. Proc. 84-42, 1984-1 C.B. 521 (advance ruling guidelines for contingent and escrowed stock in reorganizations)

Private Letter Rulings

PLR 9827027 (April 3, 1998) (example of private ruling on contingent and escrowed stock)
PLR 9838007 (June 16, 1998) (after tax-free merger with contingent stock, surviving corporation acquired in second tax-free reorganization, and stock of second acquiring corporation substituted for contingent stock from first merger; IRS rules second acquisition does not affect tax-free status of first merger)

Published Articles


TAX-FREE ACQUISITIONS — CONTINGENT LIABILITIES

Code Provision

Section 381(c)(16) (in acquisitive reorganization, P succeeds to deduction of T liabilities, except those which reduce consideration paid in reorganization; see also section 381(c)(4))

Regulations

Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a), (c) (deductibility of payments of T obligations by P after reorganization)
Reg. § 1.1502-76(b)(4) Example (5) (if T leaves consolidated group, deduction for contribution to qualified retirement plan for year may be either claimed for year in which payment is made or allocated ratably between the two short years)
**Court Decisions**

- **F. Tinker & Sons Co. v. Commissioner**, 1 B.T.A. 799 (1925) (on incorporation of partnership business, corporation agreed to pay undetermined bill for legal services to partnership; payment *held* not deductible as part of cost of acquired assets)

- **Caldwell & Company v. Commissioner**, 26 B.T.A. 790 (1932), aff’d per curiam 65 F.2d 1012 (2d Cir. 1933) (after incorporation of partnership, corporation reimbursed partners for tax and legal fees to resolve later partnership tax controversy; payment *held* not deductible, either as voluntary payment or as consideration for partnership assets)

- **Automatic Sprinkler Company of America v. Commissioner**, 27 B.T.A. 160 (1932) (corporation paid tax and interest on later-assessed deficiency of its predecessor; payment for interest *held* not deductible as part of consideration for predecessor’s assets)

- **F. S. Stimson Corp. v. Commissioner**, 43 B.T.A. 303 (1938) (on incorporation of real property, corporation assumed shareholders’ unliquidated liability under lease guaranty; payment *held* not deductible, as either dividend or part of asset cost)

- **Brown Fence & Wire Co. v. Commissioner**, 46 B.T.A. 344 (1942) (in earlier litigation, successor corporation held liable for predecessor corporation’s stock transfer tax, because successor had assumed predecessor’s liability; payment of tax *held* not deductible because part of cost for predecessor’s assets)

- **Holdcroft Transportation Co. v. Commissioner**, 153 F.2d 323 (8th Cir. 1946) (after incorporation of partnership, transferee corporation paid contingent tort liabilities incurred by partnership; payment *held* not deductible because part of consideration paid for partnership business)

- **W. D. Haden Co. v. Commissioner**, 165 F.2d 588 (5th Cir. 1948) (tax liability assumed in tax-free merger capitalized when paid; post-merger interest deductible)

- **H. Hamburger Company v. Commissioner**, 8 T.C.M. (CCH) 780 (1949) (successor corporation’s payment of predecessor’s unassumed debts to improve successor’s credit rating deductible by successor)

- **Portland Gasoline Company v. Commissioner**, 181 F.2d 538 (5th Cir. 1950) (payment by successor corporation of liability on guarantee of corporate predecessor *held* not deductible as cost of reorganization)

- **Hanna Furnace Corp. v. Kavanaugh**, 50-2 USTC ¶ 9443, 42 AFTR 1312 (E.D. Mich. 1950) (S transferred the stock of its subsidiary, T, to A, in exchange for A stock; 5 years later, S paid T tax and interest, under an indemnity; held, interest payments by S not deductible to T but part of S’s purchase price for the A stock)

- **Kaufmann v. Commissioner**, 10 TCM (CCH) 790, PH TCM ¶ 51250 (1951) (shareholders of corporation acquired in merger paid corporation’s pre-merger state and federal tax liabilities and related interest and litigation costs 6 years after closing; held, capital contributions by shareholders, increasing their basis in acquiring corporation stock)

- **Flint and Fulton, Inc. v. Commissioner**, T.C. Memo. 1956-252 (under section 351 predecessor, taxpayer transferred frozen food business to Newco in exchange for Newco preferred stock and guaranteed no loss on sale of transferred inventory; guarantee payment *held* not deductible to taxpayer, because made to encourage IPO of Newco stock, not to promote business)

- **United States v. Minneapolis & St. Louis Railway Co.**, 260 F.2d 663 (8th Cir. 1958) (successor in insolvency reorganization agreed to pay retroactive wage increases to
employees to settle predecessor’s labor dispute; payment held deductible to successor under all-events test, not assumption of predecessor’s liability; Holdcroft distinguished

United States v. Smith, 418 F.2d 589 (5th Cir. 1964) (partnership business incorporated while litigation pending on claim by former partner against partnership and other partners, and corporation paid to settle claim; case remanded with instructions that payment deductible, if liability was assumed, and purpose of assumption was not to acquire partnership property)

McGlothlin Estate v. Commissioner, 370 F.2d 729 (5th Cir. 1967), aff’g 44 T.C. 611 (1965) (in merger agreement, target shareholder agreed to indemnify acquiror if certain properties of target could not be sold for specified amount; indemnity payments not deductible to shareholder but added to basis of stock received in merger)

Edwards v. United States, 70-1 USTC ¶¶ 9188, 12,654, 25 AFTR 2d 526 (W.D. Pa. 1970) (in tax-free stock exchange, portion of acquiror stock issued was placed in escrow against certain contingencies; 4 years later, target shareholders paid cash to have the stock released from escrow; held, payment not deductible but treated as part of cost of acquiror stock issued to paying shareholders)

Oakley v. Commissioner, T.C. Memo. 1972-28 (in merger, shareholders of acquiror agreed to forgive debt owed to them by acquiror to reduce acquiror’s deficit; debt forgiveness held capital contribution that added to stock basis; no loss allowed)

M. Buten & Sons, Inc. v. Commissioner, T.C. Memo 1972-44 (on incorporation of partnership business, corporation assumed unfunded pension obligation to deceased partner’s widow; payments held not deductible but added to cost of partnership assets when made; other payments under later agreement with partners still living held deductible)

VCA Corp. v. United States, 77-2 USTC ¶¶ 9554, 9736, 40 AFTR 2d ¶ 77-5429, unpublished opinion noted 566 F.2d 1192 (Ct Cl. 1977) (just before T’s tax-free merger into P, T terminated employment contract with G; T shareholders agreed to indemnify P for part of costs of G’s termination; G sued P for damages; P paid to settle suit and was partly indemnified; IRS conceded deductibility of payment not indemnified, under section 381(c)(16); indemnified payment held deductible under literal language of regulations under sections 381(c)(4) and 381(c)(16); also, deduction gives parties no advantage over deduction by T; see published articles cited in opinion)

Revenue Rulings

Rev. Rul 73-146, 1973-1 C.B. 61 (T could deduct amounts paid by it to employees to terminate nonqualified stock options, in connection with B reorganization)

Rev. Rul. 80-198, 1980-2 C.B. 113 (on incorporation of its business, cash method proprietorship transferred receivables, and cash method corporation assumed payables; corporation reports receivables as income when collected and deducts payables when paid)


Rev. Rul. 83-155, 1983-2 C.B. 38 (cash method partnership made guaranteed payments to retired partner and deducted them; after incorporation of partnership business, cash method corporation may continue to deduct the payments)
Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent environmental liabilities of transferor assumed in section 351 transfer of business not "liabilities" for section 357(c) purposes; amounts deductible by transferee as incurred; Holdcroft not followed)

Action on Decision, General Counsel Memorandum, Private Letter Ruling, Technical Advice Memorandum and Field Service Advice

PLR 9715008 (December 4, 1996) (contingent payments in redemption of partnership interest allocated between principal and interest)
TAM 9716001 (June 17, 1996) (After transfer by T of business to P under section 351, P paid vacation pay accrued to T's employees and was reimbursed by P; P may deduct payments under section 404(a); reimbursement not income to P and does not reduce deduction)
FSA 199905008 (October 29, 1998), modified by FSA 199929015 (April 20, 1999) (Section 357(b) does not apply to assumption of contingent liability by transferee corporation in section 351 exchange; under section 358(a), transferor's basis in stock of transferee does not take contingent liabilities into account; on facts, however, no business purpose was shown for the exchange, which resulted in claimed loss on sale of transferee stock, so that section 351 did not apply; Rev. Rul. 95-74 distinguished).

Published Articles and Bar Association Reports

See articles and reports cited in TAXABLE ACQUISITIONS — CONTINGENT PURCHASE PRICE, above.