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Contingent Purchase Price, Contingent Liabilities and Indemnities in Taxable Acquisitions (Slides)

William M. Richardson

William and Mary Law School, wmrichardson@wm.edu

Robert H. Wellen

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**CONTINGENT PURCHASE PRICE,
CONTINGENT LIABILITIES AND INDEMNITIES
IN TAXABLE ACQUISITIONS**

PROGRAM SLIDES

**WILLIAM AND MARY TAX CONFERENCE
KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA
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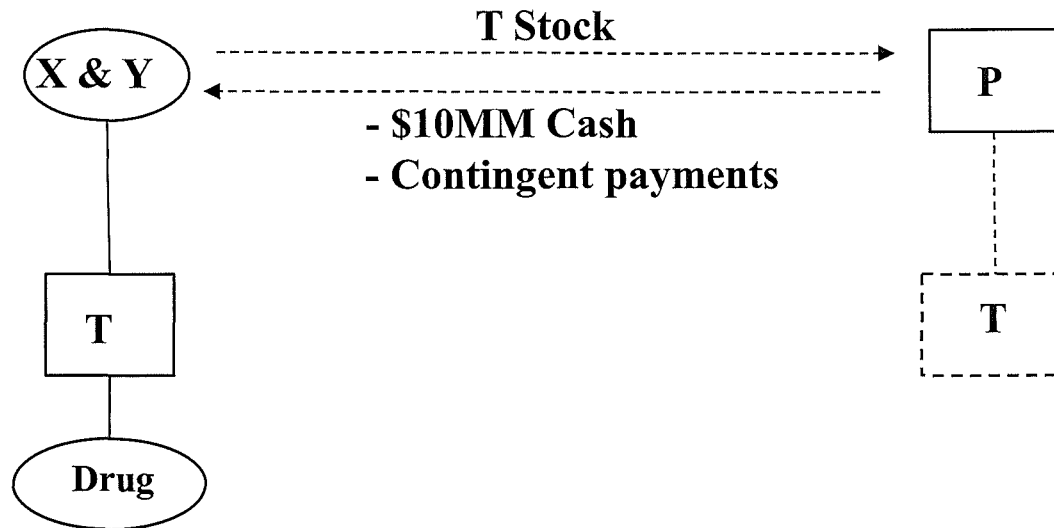
**WILLIAM M. RICHARDSON
WILLIAM AND MARY LAW SCHOOL
WILLIAMSBURG, VIRGINIA**

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

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Contingent Purchase Price Seller Consequences Discussion Problem—Facts



- X owns 80% and Y owns 20% of the T stock. Stock basis = \$0.
- T has developed Drug, which might cure a dreaded disease, but no clinical trials leading to regulatory approval have been held.
- Unrelated P corporation wants to acquire Drug.
- X and Y sell all the T stock to P for:
 - \$10MM cash
 - Right to payments up to \$100MM cash if and as regulatory approval milestones occur
 - Right to percentage of sales of Drug, in cash, with no cap
- In its financial statements, P reports a \$25MM liability for the contingent payments to X and Y.

Contingent Purchase Price Seller Consequences Discussion Problem—Analysis

Three possible methods of reporting:

Closed transaction

- Gain taxed at closing = cash received + FMV of contingent payment right
 - A's gain = \$8MM + \$20MM (?). All long-term capital gain
 - B's gain = \$2MM + \$5MM (?). All long-term capital gain (nearly all the cash is needed to pay tax)
- Gain or loss on receipt of contingent payments
 - Recovery of basis up to FMV taxed at closing
 - Gain if payments received total more than the FMV taxed at closing — may be ordinary income or capital gain
 - Loss if payments received total less than the FMV taxed at closing — may be ordinary or capital loss (Note: Capital loss may be unusable)
 - Imputed interest taxed as ordinary income as cash received

Open transaction

- Gain taxed at closing = cash received; long-term capital gain
- Gain on contingent payments taxed as received; long-term capital gain except imputed interest

Installment method

- Gain taxed at closing = cash received; all long-term capital gain
- Gain on contingent payments taxed as received; long-term capital gain except imputed interest
- Section 453A deferral charge on “deferred tax liability” for installment obligations totaling more than \$5MM (“Deferred tax liability” computed as described in Slides 16-18)

See also §1202 (tax-free sale of small business corporation stock)

**Contingent Purchase Price
Seller Consequences
Closed Transaction Method—Treatment at Closing**

- Reg. §1.1001-1(g)(2)
 - Amount realized on sale includes FMV of contingent payments
 - In determining FMV, restrictions on transfer of payment right are not taken into account
 - FMV of contingent payments cannot be less than FMV of property sold, less other amounts realized
 - Taxable at closing of sale
- Old case law suggested that cash method Seller could defer tax until receipt of “cash equivalent,” but regulations reject this case law
 - *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), *rev’g* 60 T.C. 663 (1973)
 - Reg. §15a.453-1(d)(2)(i)

**Contingent Purchase Price
Seller Consequences
Closed Transaction Method
Character of Gain or Loss on Receipt of Contingent Payment**

- Each payment is treated as part-principal and part-interest, if adequate interest is not stated (§483 or §1274; Reg. §§1.483-4 and 1.1275-4(c)(4))
 - In most acquisitions, interest portion is ordinary income to Seller and deductible to Buyer, but only when contingency is fixed
 - No OID or other interest income accrual before contingency is fixed
 - Principal first goes to recover basis of contingent payment right (FMV included in amount realized at closing)
 - Excess of principal payments received over basis of contingent payment right = gain
 - Excess of basis in contingent payment right over principal payments received = loss
 - But loss may be deducted only when no more contingent payments are expected
- Character of gain or loss
 - Character of gain or loss on sale may govern character of contingent payment right (*Arrowsmith v. Commissioner*, 344 U.S. 900 (1952))
 - If *Arrowsmith* does not apply, character is uncertain and may depend on whether contingent payment right is a “debt instrument” or a “contract right”

**Contingent Purchase Price
Seller Consequences
Closed Transaction Method
Character of Gain or Loss—Debt Instrument or Contract Right?**

- In a number of cases, courts have tried to determine—
 - If a contract right to receive ordinary income (*e.g.*, winning lottery ticket, real property lease by owner, right to sell or purchase electric power) is a capital asset, resulting in capital gain or loss on sale
 - If a transaction in which a contract right holder is paid under the contract or in settlement thereof is “sale or exchange” resulting in capital gain or loss
- Section 1234A may allow capital gain and require capital loss
 - Is payment received under terms of contract a payment in “cancellation, lapse, expiration or other termination” of contract?
 - Case for capital gain or loss under §1234A is weakened where contract calls for stream of payments, not a single payment (unless right to each payment is treated as a separate contract)

**Contingent Purchase Price
Seller Consequences
Closed Transaction Method
Character of Gain or Loss if Debt Instrument**

- Section 1271(a) imposes exchange treatment at maturity of a debt instrument, overruling *Fairbanks v. United States*, 306 U.S. 436 (1939)
 - This treatment would produce capital gain or loss
 - “Debt instrument” broadly defined in §1275 regulations
 - But uncertainty remains under debt vs. contract case law, where right to future payments is contingent on future events

**Contingent Purchase Price
Seller Consequences
Closed Transaction Method
FMV of Contingent Payment Rights Underestimated or Overestimated
Character of Gain or Loss**

- What happens if Seller receives more contingent payments than expected?
 - Possible conversion of contingent payment right from capital gain on sale to ordinary income:
 - *Arrowsmith v. Commissioner*, 344 U.S. 900 (1952) may not apply
 - Contingent payment right is determined to be contract right, not debt instrument
- If Seller receives less contingent payments than expected, and if loss is capital loss, the loss can be orphaned:
 - If Seller is an individual, no capital loss carryback
 - If Seller is a C corporation, 3-year capital loss carryback

**Contingent Purchase Price
Seller Consequences
Open Transaction Method—General**

- Based on *Burnet v. Logan*, 283 U.S. 404 (1931); *see also Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq.* 1948-1 C.B. 2
- Available only in “rare and extraordinary cases” where FMV of contingent payment right is not reasonably ascertainable (Reg. §1.1001-2(g)(2)(ii))
- Compare *Dorsey v. Commissioner*, 49 T.C. 606 (1968) and *MacDonald v. Commissioner*, 55 T.C. 840 (1971) (open transaction method allowed) with *In re Steen v. United States* (Slide 33) (open transaction method partially allowed)

**Contingent Purchase Price
Seller Consequences
Open Transaction Method—Comparison with Other Methods**

- Advantages compared with installment method:
 - Full front-end basis recovery against cash as received.
 - No §453A deferral charge.
- Compared with closed transaction method:
 - Advantage: All proceeds, other than imputed interest, eligible for capital gain treatment.
 - Disadvantage: No loss until remaining basis exceeds possible remaining payments.

**Contingent Purchase Price
Seller Consequences
Open Transaction Method—Recent Support**

- Despite hostility in the regulations and recent commentary, the open transaction method is still available in some situations
- Some recent court decisions are supportive:
 - *Fisher v. United States*, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Aug. 6, 2008), *aff'd without opinion*, 2009 WL 3241381 (Fed. Cir. 2009) (in life insurance company demutualization, policyholders who received cash in lieu of stock entitled to allocate *all* premium costs to basis in stock, on open transaction theory)
 - But in *Dorrance v. United States*, 877 F. Supp. 827 (D. Az. 2012), and *Reuben v. United States*, 111 AFTR 2d 2013-620 (C.D. Cal. 2013), the district courts rejected open transaction treatment in similar situations
 - *Anschutz Company v. Commissioner*, 135 T.C. 78 (2010), *aff'd* 108 AFTR 2d 2011-7590 (10th Cir. 2011) (Tax Court allows open transaction treatment for contingent purchase price in complex financial transaction treated as sale)

Contingent Purchase Price Seller Consequences Installment Sale—General

- Defers tax on gain from future payments until received
- Applies only to gain, not loss
- General rule is *pro rata* basis recovery
- If there is a maximum selling price, basis is recovered on assumption that maximum price will be received
- If there is no maximum selling price, but there is a time limitation, basis is recovered straight-line over maximum time for payments
- If there is neither maximum selling price nor time limitation—
 - Basis recovery is straight-line over 15 years unless general rule would inappropriately accelerate basis recovery:
 - Seller may request PLR
 - IRS may require basis recovery on non-straight-line basis
 - Losses are deferred until all amounts have been recovered
 - Is the transaction really a sale?
- Each payment is treated as part-principal and part-interest (Slide 4)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Method—Limitations

- Applies only to gain, not loss
- Not available for—
 - Sale of inventory (including bulk sale) with exceptions for farm property, timeshares and residential lots
 - Sale of marketable securities
 - Sale for a demand note or a note that is readily tradable
 - Sale of depreciable property
 - Depreciation recapture gain not eligible for deferral
 - Sale of depreciable property to related person—
 - Generally not eligible for deferral
 - If installment payments are contingent and cannot be valued, deferral is allowed; asset basis is recovered “ratably,” and Buyer’s basis is increased as gain is taxed to Seller

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Method—Triggering Taxable Gain after Sale

- Limited security on installment note is allowed without triggering gain
- If installment sale is to a related party, a second sale of the same property within 2 years triggers gain
- Disposition of installment obligation by holder triggers gain
 - Modification of installment note may constitute a disposition, but many modifications are permitted (Rev. Rul.75-457 and PLR 201144005; *compare* Reg. §1.1001-3, which does not apply)
 - If Seller is a partnership—
 - Nonliquidating distribution of installment note to partners is not a disposition
 - Sale of partnership interest is a disposition of the partner's share of the note
 - Tax-free §332/337 liquidation of C corporation (including deemed liquidation under §336(e) or §338(h)(10)) is not a disposition
 - Liquidation of S corporation is not a disposition
- Sale by non-publicly traded C corporation and liquidation within 12 months under plan of liquidation result in—
 - Triggering of gain at corporate level
 - Installment sale by shareholders of their stock for the note and other assets

**Contingent Purchase Price
Seller Consequences
Installment Sale**

Multiple Assets—Allocation of Cash and Installment Obligation

- If Seller sells multiple assets to Buyer, can an installment obligation be allocated in kind to low-basis assets and cash to high-basis assets (and to assets not eligible for installment method—*see* Slide 12)?
 - Results: accelerate basis recovery, defer more gain and accelerate loss
 - *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); *Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq.* 1964-2 C.B. 6; Rev. Rul. 68-13, 1968-1 C.B. 195
- Similarly, can different installment obligations be allocated to different assets, each with its own “gross profit ratio”?
 - In LAFA 20080101F, LB&I concluded that the above authorities apply only to determine character of gain or loss and to exclude assets not eligible for installment method—not to thwart ratable basis allocation or allow immediate loss and deferred gain
- Compatibility of in-kind allocation of consideration with §§1060, 336(e) and 338(h)(10)?

**Contingent Purchase Price
Seller Consequences
Installment Sale—Allocation to Services or Covenants**

- If, in connection with a sale of assets, Seller also provides services to Buyer, or enters into a covenant not to compete, may contingent purchase price be allocated to the services or to Seller's covenant?
- Payment for services—
 - Taxed to Seller on accrual or receipt (cash method) as ordinary income, with no basis offset and no deferral charge
 - Usually currently deductible to Buyer as accrued or paid, but deferred compensation rules (§§404(a)(5) and 409A) may defer deduction
- Payment for covenant—
 - Taxed to Seller on accrual or receipt with no basis offset and no deferral charge
 - Amortizable to Buyer under §197 as accrued or paid

**Contingent Purchase Price
Seller Consequences
Installment Sale
Deferral Charge—Computation, Etc.**

- Section 453A imposes a charge for deferring tax on gain deferred under installment method
- Computation:
 - Amount of deferred tax = tax at “maximum rate” on capital gain
 - “Maximum” §1(h) rate for individuals is the 28% rate on sales of collectibles, etc., even though 20% is probably the effective rate on the gain from the actual sale
 - Section 1201 determines maximum rate for C corporations
 - Interest rate is the floating underpayment rate
- Deferral charge is treated as interest (§453A(c)(5))
 - Deductible to C corporations
 - Not deductible to individuals
- Installment method has no provision to elect out later and avoid further deferral charges, *e.g.*, if interest rates increase (Reg. §15a.453-1(d)(3)(ii))
- Seller may be able to avoid deferral charges by self-help—disposition of installment obligation triggers gain on installment sale (*see* Slide 13)

**Contingent Purchase Price
Seller Consequences
Installment Sale
Deferral Charge—*De Minimis* Amounts**

- Deferral charge applies only to—
 - Installment sales of property for more than \$150K sale price
 - More than \$5MM aggregate face amount of installment obligations held by Seller at year end (excluding obligations subject to \$150K exclusion)
- *De minimis* amounts apply separately to each partner or S corporation shareholder (Notice 88-81)

**Contingent Purchase Price
Seller Consequences
Installment Sale
Deferral Charge—Contingent Payments**

- Regulations are to be issued on application of §453A to contingent payments (§453A(c)(6)), but no regulations have been issued or proposed (on 2014-2015 Priority Guidance Plan)
- Can §453A be ignored until regulations become effective?
 - Many contingent obligations do not have a “face amount,” and so *de minimis* rule may apply (or there may be no “installment obligation”)
 - FSA 199941001 (§453A self-executing without regulations)
- Until §453A(c)(6) regulations become effective, how is “deferred tax liability,” on which deferral charge is based, computed?
 - FSA 199941001 (deferral charge based on FMV of contingent payment right at closing)
 - TAM 9853002 (no refund of deferral charge based on FMV of contingent payment right at closing, even if contingent payment is never received)
 - If FMV of contingent payment right cannot be determined at closing, is there no deferral charge, even if Seller does not elect out of installment method in favor of open transaction method?
- LAFA 20080101F suggests another method, called “look back” but not described
 - Would Seller pay deferral charge on contingent purchase price when received, regardless of FMV of contingent payment right at closing?

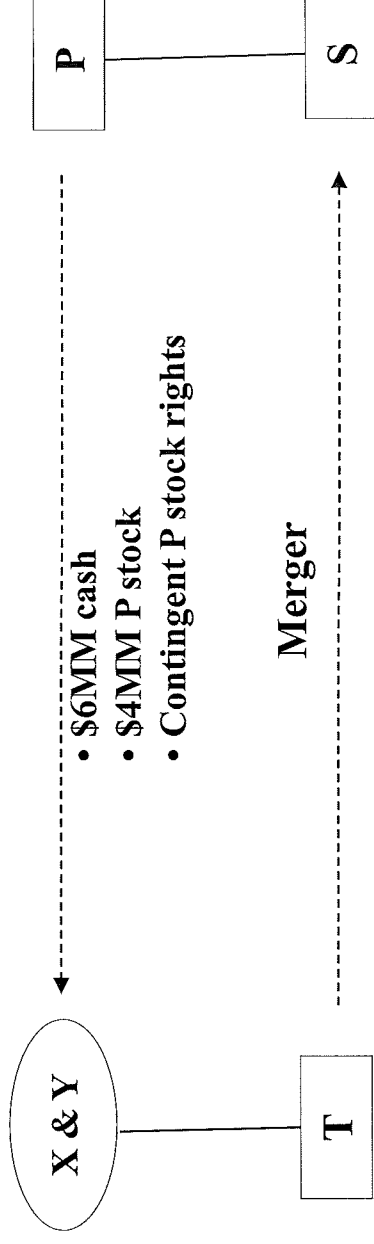
**Contingent Purchase Price
Seller Consequences
Installment Sale
Election Out—General**

- Seller may elect out by reporting sale under either of the other methods:
 - Closed transaction
 - Open transaction
- Does assumption of contingent obligations alone put Seller on installment method unless Seller elects out?
 - Election out of installment method is irrevocable except with IRS consent
 - Seller may not elect out after filing original return except for good cause with IRS consent, to be granted in “rare circumstances” (Reg. §15a.453-1(d)(3)(ii))

**Contingent Purchase Price
Seller Consequences
Installment Sale
Election Out—Erroneous Open Transaction Method**

- Consequences of electing out of installment method to claim open transaction method and being wrong:
 - Because of election out, no deferral charge
 - Regulations do not allow late revocation of election out
 - Result is closed transaction method
 - Capital gain character of contingent payments in excess of FMV at closing is jeopardized
- *But see Mamula v. Commissioner*, 346 F.2d 1016 (9th Cir. 1965)
 - Taxpayer erroneously used open transaction method for fixed-amount note on accountant's advice
 - IRS disallowed open transaction method, and taxpayer tried to elect installment method after the fact, but IRS disallowed the election
 - *Held*, IRS could not refuse to allow taxpayer to elect installment method (distinguishing *Pacific National Co. v. Welch*, 304 U.S. 191 (1938), in which original method was permissible)
 - Does IRS get to choose new method if taxpayer has selected impermissible method?

Contingent Purchase Price Seller Consequences Reorganization to Avoid Installment Sale Discussion Problem—Facts



- As in Slide 1:
 - X owns 80% and Y owns 90% of the T stock. X's and Y's stock basis = \$0
 - T has developed Drug, which might cure a dreaded disease, but no clinical trials leading to regulatory approval have been held
 - Unrelated P Corporation wants to acquire Drug
- T is merged into S, a wholly-owned P subsidiary. For their T stock, X and Y receive:
 - \$6MM cash
 - P stock, FMV = \$4MM
 - Right to additional P stock, FMV up to \$100MM, if and as regulatory approval milestones occur
 - Right to additional P stock, FMV = percentage of sales of Drug, with no cap

**Contingent Purchase Price
Seller Consequences
Avoiding Installment Sale Regime—Discussion Problem—Analysis**

- Merger qualifies as a tax-free reorganization (§368(a)(2)(D))
 - 40% continuity of interest
 - Contingent stock rights probably OK (but no cap raises a question)
- Consequences to P and S:
 - Carryover basis in T assets; no basis step-up
 - P's basis in S stock reflects \$6MM cash payment to X and Y
- Consequences to X and Y:
 - \$4MM stock tax-free but basis = \$0
 - \$6MM cash fully taxable at closing as long-term capital gain
 - Contingent stock
 - Tax-free when received (except imputed interest)
 - Basis = \$0 (again, except imputed interest)
 - No phantom gain
 - No deferral charge

Contingent Purchase Price Buyer Consequences

- Buyer gets no asset basis for contingent purchase price until fixed or paid
- Makes no difference which method Seller uses to report sale—even if Seller reports difference between amount realized at closing and amount collected as gain or loss in a separate transaction (and so does not adjust its §1060 allocation)
- As Buyer pays contingent purchase price, asset basis is increased—usually increases basis in §197 assets

Escrowed Sale Proceeds

- Seller and Buyer may agree to place part of the purchase price in escrow account, *e.g.*, to secure Seller's indemnity and other obligations.
- Issues:
 - Is Seller deemed to receive escrowed proceeds upon establishment of escrow at closing (installment sale, closed transaction or open transaction)?
 - Who is taxed on income earned by the escrowed funds during the escrow period?

Escrowed Sale Proceeds

Timing of Inclusion in Seller's Amount Realized

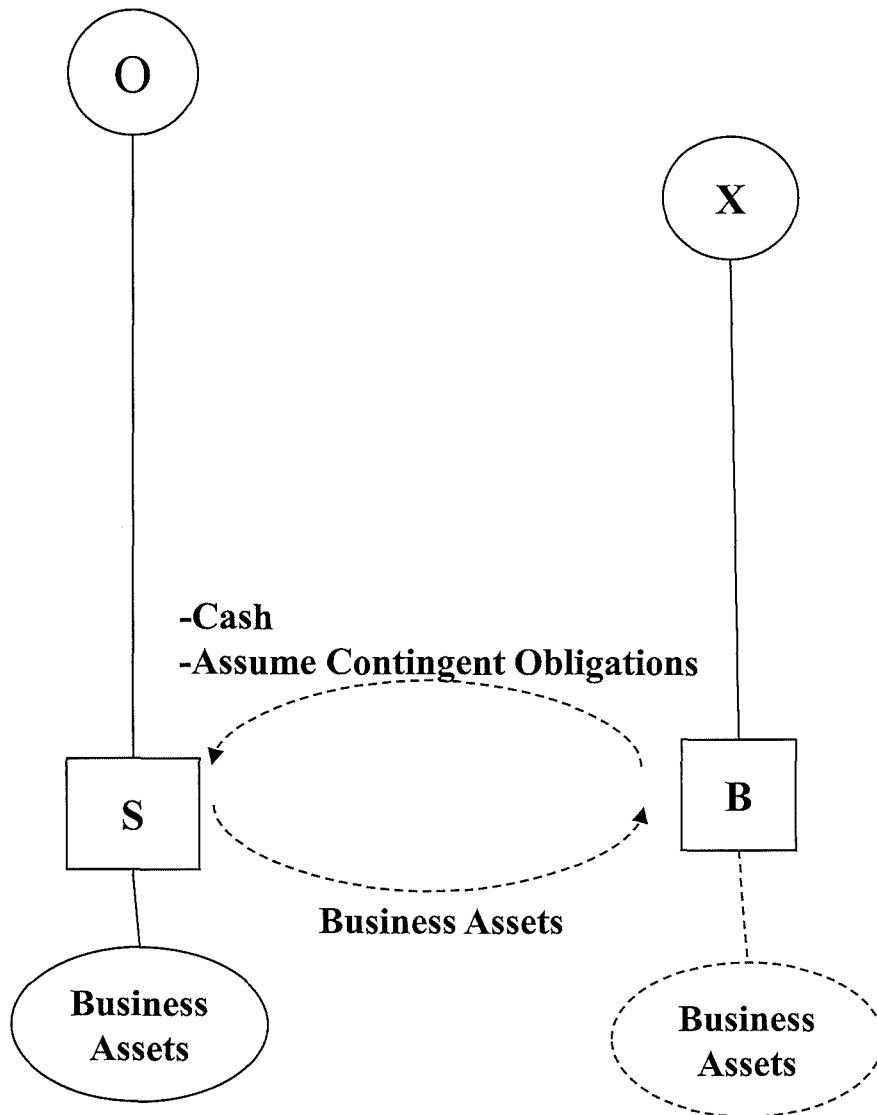
- If escrow protects Seller (*e.g.*, to secure Buyer's payment of purchase price), Seller is deemed to receive escrow proceeds in year of sale
- If escrow is under Seller control (*e.g.*, investment authority), Seller's amount realized includes escrowed funds (*Chaplin v. Commissioner*, 136 F.2d 298 (9th Cir. 1943); *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937))
- If escrow protects Buyer (*e.g.*, to secure Seller indemnities), amount realized for escrow proceeds is deferred until payment to Seller becomes fixed
 - IRS agrees that sale with escrow for Buyer's benefit is eligible for installment method (Rev. Rul. 77-294, 1977-2 C.B. 173, *amplified* Rev. Rul. 79-91, 1979-1 C.B. 179; IRS Pub. 537 (citing "substantial restriction" requirement); PLR 200521007)
 - Case law supports contrary argument (*Granneman v. United States*, 649 F. Supp. 949 (E.D. Mo. 1986) (note intended to be paid by Buyer, not out of escrow))
 - escrow with "substantial restrictions" could be reported on open transaction method

Escrowed Sale Proceeds Taxation of Escrow Income

- “Homeless income”
- Congressional response: §468B(g)(1)
- 1999 proposed regulations would tax *Buyer* on the income from escrowed funds until Seller’s right to the funds becomes fixed
- Until regulations are finalized, either Buyer or Seller may be allocated the escrowed income by contract (subject to general economic substance requirements)
- Parties’ agreement as to which party reports income does not impact timing of Seller’s gain recognition on sale, or vice versa (Prop. Reg. §1.468B-8(d); *Anderson v. Commissioner*, 20 T.C.M. 697 (1961))

Assumption of Contingent Obligation in Asset Acquisition

Discussion Problem



- **Year 1:**
 - B buys Business Assets from S
 - B pays cash and assumes S's contingent obligations
- Disposition of assumed contingent obligations:
 - **Each year:** B pays medical benefits to retirees
 - **Each year:** B pays warranty claims in amounts less (or more) than expected
 - **Years 2-4:** B pays deferred compensation, some vested before and some after sale
 - **Year 5:** B pays for clean-up of S's waste site
 - **Year 6:** B pays unexpected judgment in a patent infringement case
 - **Years 1-6:** B complies with fixed-price contracts, both favorable and unfavorable
- Three tax treatments possible for assumption of contingent obligations:
 - B expense
 - Usually deductible to B when paid or accrued (including economic performance)
 - No effect on S
 - S expense paid by B
 - Capitalized in price paid for Business Assets
 - Added to S's amount realized on sale, with offsetting deduction
 - "Fee" analysis (*James M. Pierce Corp.*, etc. (Slides 32-33))

**Assumption of Contingent Obligation
in Asset Acquisition
Consequences—Buyer Expense Treatment**

- Buyer deducts or capitalizes obligation as Seller would have
- Deduction or asset basis increase occurs when obligation is accrued or paid (economic performance) under general tax accounting rules
- No gain, income or deduction to Seller

Assumption of Contingent Obligation in Asset Acquisition Consequences—Assumed Contingent Liability Treatment Seller

Inclusion in Amount Realized

- Seller is relieved of an obligation
- Seller's amount realized is increased
 - One approach is to value the obligation at closing and increase the amount realized at closing by that amount, with adjustments later (“closed transaction”)
 - Other approach is to increase amount realized only when contingency becomes fixed and determinable (“open transaction”)

Is Interest Imputed on Deemed Payment?

- This issue should only apply to open transaction approach
- Arguably there is no imputed interest, because §1274 does not apply to assumed debt (§1274(c)(4))
- Does § 483 require imputed interest upon payment?

Installment Reporting

- If open transaction approach is taken, is sale an installment sale because of possible future payment?
 - Section 453 regulations do not discuss assumption of contingent obligations
 - If payment of obligation is treated as payment of purchase price, sale literally falls within definition of contingent payment installment sale
 - Could lead to deferral charge

Assumption of Contingent Obligation in Taxable Acquisition

Consequences—Assumed Contingent Liability Treatment Seller (Continued)

Does Seller get offsetting deduction against amount realized?

- Seller should get a deduction (*Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981))
 - Court said that obligation assumed by Buyer reduced cash received by Seller
 - Such reduction in cash received treated as if Seller actually paid the obligation
 - Seller gets a deduction to offset income

If so, when?

- Reg. §1.461-4(d)(5) provides that, in a sale of a business, if Buyer “expressly assumes” an accrued liability, economic performance occurs as the liability is included in Seller’s amount realized
- Regulation is too narrow
 - It requires an express assumption
 - It covers only the economic performance requirement, not the all-events test
 - Treas. Reg. §1.461-4(j) reserves treatment of contingent obligations
- If the regulations test is failed, Seller may have income with no matching deduction until later
 - Presumably deduction is deferred until Buyer makes payment, or amount is fixed
 - This is the wrong answer—in acquisition context Seller should not be subject to economic performance
 - §461(h) was intended to prevent premature accrual
 - If Seller has income recognition, accrual is not premature
 - If Seller does not get deduction at closing, no clear reflection of income
 - Does *Commercial Security Bank* apply if §461(h) requirements are not met?
- Similar problem arises where obligation is to pay nonqualifying deferred compensation
 - Section 404(a)(5) – employer gets deduction when employee has income
 - IRS position: deemed payment found in *Commercial Security Bank*, etc. does not support a deduction until income to employee (TAM 8939002)

**Assumption of Contingent Obligation
in Asset Acquisition
Consequences—Assumed Contingent Liability Treatment
Buyer**

- Treat assumed obligation as cost of purchased assets and add to asset basis
- Capitalization approach has greater support in case law
 - *Webb* (Slide 37)
 - Unfunded pension obligation assumed in asset acquisition
 - Payments treated as cost of acquired assets
 - *Holdcroft Transportation Co. v. Commissioner* (Slide 35); *Pacific Transport* (Slide 39); *M. Buten & Sons* (Slide 37)
- Uncertain whether Buyer may treat a portion of the payments as currently-deductible interest when made (no OID)
 - Section 1274 does not apply to obligation assumptions
 - Does §483 apply?
- Addition to asset basis is delayed to when obligation becomes fixed (accrual and economic performance)
- But, if Buyer sells asset subject to the same contingent obligation before the obligation is added to asset basis, assumption of the obligation from Buyer is excluded from Buyer's amount realized on this sale (Reg. §1.1001-2(a)(3))

Assumption of Contingent Obligation in Taxable Acquisition Consequences—“Fee” Treatment

***James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir.1964),
rev’g 38 T.C. 643 (1962)**

- Seller owned a newspaper and received prepaid subscription fees
- Seller set up a cash reserve and deferred the income under §455
- Both Tax Court and Court of Appeals held that, when Seller sold the business, it had to accelerate the reserve and report it as income
- But, reversing Tax Court, Court of Appeals also gave Seller an offsetting deduction:
 - Buyer deemed to pay cash to Seller for reserve (Seller’s taxable income)
 - Seller is deemed to turn around and pay Buyer a “fee” for assuming obligation to fill newspaper subscriptions
 - Thus Seller’s income from the reserve was offset with a deduction for the “fee”
- If Buyer is treated consistently with Seller—
 - Deemed receipt of fee would be currently taxable to Buyer
 - Deemed reduction in purchase price for assumption of obligation would be added back to Buyer’s basis in purchased assets at closing
 - Payment of obligation should be currently deductible

Assumption of Contingent Obligation in Asset Acquisition Consequences—“Fee” Treatment

Other Authorities

- Rev. Rul. 68-112, *amplified*, Rev. Rul. 71-450: Fee paid by Seller to Buyer of newspaper for assumption of prepaid subscriptions deductible to Seller and income to Buyer.
- *TFH Publications v. Commissioner*, 72 T.C. 623 (1979): Acquisition of publishing company assets with agreement to provide future advertising services at a discount
- TAM 9832002: Prepaid subscription income treated as assumed obligation
- Fee approach has not received much support outside publication industry
- But preamble to a consolidated return regulation (T.D. 9376 (Jan. 16, 2008)) implies that fee theory applies in §332 liquidation if shareholder assumes obligation to provide future services (but supporting example involves prepaid subscription income)
- Different approach is implied in *In re Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (buyer of uranium mine paid seller additional purchase price due to favorable state tax decision; *held*, open transaction; fee income to buyer not asserted)

**Assumption of Contingent Obligation
in Asset Acquisition
Factors in Determining Treatment**

1. Does the obligation result from Seller's or Buyer's operations?
2. Does the obligation result from pre-acquisition or post-acquisition events?
3. Did legal obligation arise before or after closing?
4. Was Buyer aware of obligation (balance sheet reserve) at closing?
5. Did Buyer expressly assume the obligation, and was the obligation reflected in purchase price?

Assumption of Contingent Obligation in Asset Acquisition First Factor

Results from Seller's or Buyer's Operations?

- Whether the obligation results from—
 - Seller's or Buyer's operation of the business
 - Activities performed by Seller or Buyer
 - Events under Seller's or Buyer's control
 - Seller's or Buyer's decisions
- *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946):
 - Buyer acquires assets in nonrecognition transaction, in exchange for Buyer stock and assumption of Seller's obligations, including tort claims
 - Buyer pays claims and deducts payments
 - Buyer argues that it steps into Seller's shoes and may deduct payments
 - Buyer also argues it may deduct payments because claims were contingent
 - Court holds:
 - Claims arose from Seller's business
 - Buyer may not deduct costs relating to Seller's business
 - Fact that obligation was contingent does not matter
 - Buyer assumed obligations part of costs of assets

Assumption of Contingent Obligation in Asset Acquisition First Factor—Continued

Results from Seller or Buyer Operations—Other Authorities

- *Albany Car Wheel v. Commissioner* (Slide 38) – obligation arose after acquisition due to Buyer's decision to close plant
- Rev. Rul. 76-520 – Buyer acquired newspaper business
 - Costs of filling prepaid subscriptions was assumed obligation because it relates to Seller operations
 - Costs of selling newspapers at newsstands deductible because they related to Buyer operations
- TAM 9721002 – acquisition and severance pay:

“[A]lthough severance payments here were coincidental with Buyer's acquisition of Target, the severance payments had their origin in Buyer's termination of Target employees. While the acquisition may have been the catalyst for the employees' receipt of the severance payments, the acquisition was not itself the basis for the payments. Accordingly, the severance payments need not be capitalized and added to the basis of the stock purchased.”
- *Illinois Tool Works v. Commissioner*, 355 F.3d 997 (7th Cir. 2004) – Because Buyer knew of pending patent infringement lawsuit and agreed to pay that contingent obligation in exchange for purchasing the company, Buyer had to capitalize and amortize its payment of the judgment

Assumption of Contingent Obligation in Taxable Asset Acquisition Second Factor

Results From Pre-Acquisition or Post-Acquisition Events

- A factor closely related to the first factor is whether the obligation results from pre-acquisition or post-acquisition events
- For example, where there is a contract in place at time of acquisition to pay death benefits to employees:
 - If employee dies after closing, obligation should be a Buyer obligation
 - If employee has died and Seller is obligated to pay, Buyer assumes obligation—no deduction to Buyer
- *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44
 - Corporation assumes liabilities of partnership in §351 transaction, including death benefits to surviving widows
 - No deduction for payments to widow of employee who died before acquisition
 - Payments were deductible if employee died after acquisition
- *David R. Webb Co., Inc. v. Commissioner*, 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983)
 - Buyer assumed Sellers obligation to make pension payments to wife of previously deceased employee
 - No deduction to Buyer

Assumption of Contingent Obligation in Asset Acquisition Third Factor

When did Legal Obligation Arise?

- Courts have held that legal obligation for a tort arises when the tort occurs
 - *Holdcroft* (Slide 35) and *Pacific Transport* (Slide 39) support the idea that contingent nature of obligation to pay tort claim is not relevant
- Compare cases where obligation represents contract claim, not tort – *Albany Car Wheel Co. v. Commissioner*, 333 F.2d 653 (2d Cir. 1964))
 - Collective bargaining agreement required severance payments to employees upon plant shutdown
 - Purchase agreement called for express assumption of the severance obligation
 - After assets were transferred, plant was shut down, and Buyer made severance payments
 - Court held that obligation did not arise until after closing when plant shut down, and obligation arose on Buyer's side

Assumption of Contingent Obligation in Asset Acquisition Fourth Factor

Was Buyer Aware of Obligation?

- *Pacific Transport v. Commissioner*, 483 F.2d 209 (9th Cir. 1973)
 - Parent corporation liquidated subsidiary (former §334(b)(2)) and took assets and assumed liabilities, including a lawsuit
 - Parent believed its risk on the claim was remote.
 - Parent's risk assessment was wrong, and it ultimately paid the claim.
 - Tax Court held that deduction was allowed, because claim was speculative and remote
 - Appeals court reversed and held that contingency was irrelevant
 - Because Buyer was aware of obligation, payment of claim was a cost of acquiring assets
 - No exception to capitalization for bad bargains
- Reserve for liability on Seller's balance sheet would make Buyer aware of obligation
- *See Illinois Tool Works v. Commissioner* (Slide 36)

Assumption of Contingent Obligation in Asset Acquisition Fifth Factor

Obligation Expressly Assumed by Buyer and Reflected in Price

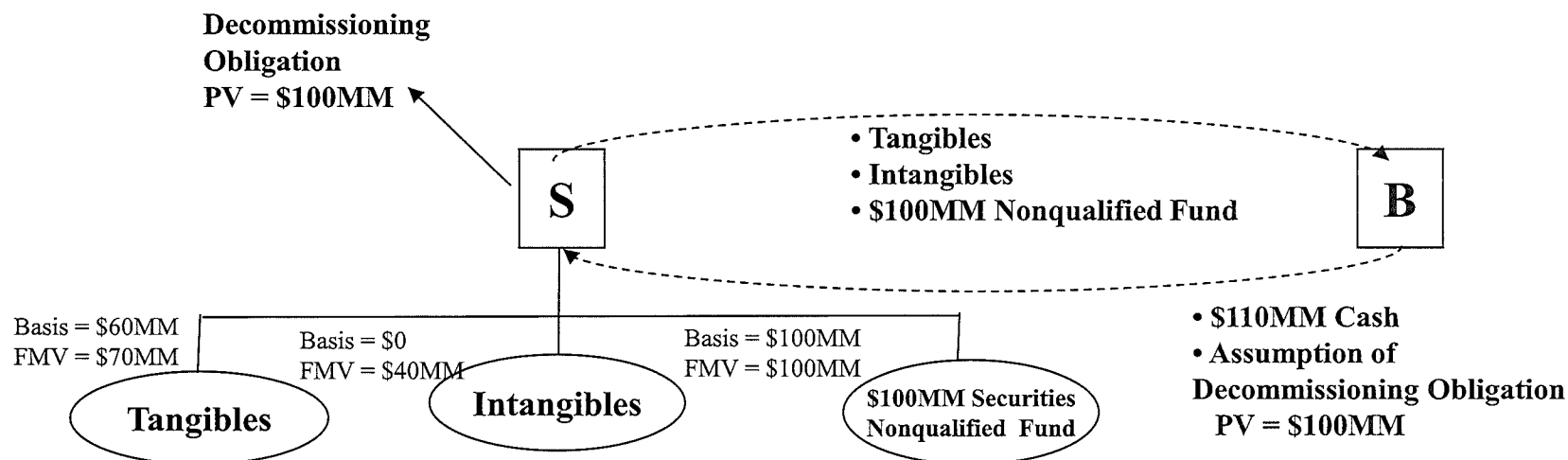
- Was purchase price reduced on account of the contingent obligation? If so, the obligation looks like an assumed liability
- This factor comes up where—
 - Purchase price based on balance sheet
 - Reserve on balance sheet
- Allows IRS to argue that the liability was reflected in the price
- If Buyer expressly assumes a liability of Seller, courts generally conclude that Buyer must capitalize payment of the assumed liability
- But this factor alone should not be dispositive (*Albany Car Wheel* (Slide 38))

Assumption of Contingent Obligation in Asset Acquisition Contracts Transferred to Buyer

- Acquired business may have favorable or unfavorable contracts, or both
- Favorability of a contract could be measured by reference to expected profit or loss on compliance or, even if profit is expected, based on the taxpayer's normal or baseline margin
- Under GAAP purchase accounting (PACO), Buyer must reserve for estimated costs of compliance with unfavorable contracts as additions to purchase price (FASB Statement No. 38)
- Consequently, if Buyer deducts these costs for tax purposes, Schedule M-3 adjustments result
- Unfavorable contracts could be viewed as reducing value of acquired assets, *e.g.*, goodwill, instead of contingent liabilities. Result: compliance costs deductible to Buyer (*see Daishowa-Marubeni International Ltd. v. Canada*, 2013 SCC 29 (2013) (timberland Buyer assumed Seller's obligation to reforest; assumption not added to Seller's amount realized, because not a distinct liability but a future cost that depressed property FMV))
- If net costs of compliance with unfavorable contracts were treated as assumed contingent liabilities, should net income from favorable contracts be excluded from Buyer's income and treated as reduction in purchase price?
- PLR 200730014 (July 27, 2007)
 - Purchaser of gas marketing business paid customers to terminate pre-existing contracts to supply gas at fixed price and substitute contracts at fluctuating prices
 - Payments deductible to Buyer, not capitalized as adjustments to purchase price, because—
 - Obligations contingent on customers' gas purchases and market price
 - Contracts not taken into account in determining purchase price
- *Albany Car Wheel* (Slide 38)
 - No step-up in cost basis of business assets for Buyer's payment of severance pay
 - Buyer negotiated new collective bargaining agreement providing for severance pay
- *See also* §1274(c)(4) (in asset purchase, interest not imputed to account for favorable or unfavorable financing)

Assumption of Contingent Obligation in Asset Acquisition

Discussion Problem—Nuclear Power Station Decommissioning



- S owns a nuclear power plant
 - S's basis in tangible assets is \$60MM, and FMV is \$70MM
 - S's basis in intangibles is \$0, and FMV is \$40MM
 - The plant is expected to be decommissioned in 2054 at \$500MM cost (present value = \$100MM)
 - S has set aside securities (\$100MM basis and FMV) in a "nonqualified fund" to fund this cost
- S sells the plant to B in 2014
 - S transfers the tangibles, intangibles and nonqualified fund to B
 - B pays S \$110MM cash and assumes the decommissioning cost obligation
- After the sale until 2054, the securities in the nonqualified fund increase in FMV to \$500MM
- In 2051, the plant is decommissioned at \$500MM cost, paid out of the fund

See PLR 200126011 (Mar. 26, 2001) and other PLRs; *AmerGen Energy Co. LLC v. United States*, 112 AFTR 2d 2013-6376 (Ct. Fed. Cl. 2013); Reg. § 1.338-6(c)(5); See also *United States v. ConocoPhillips Co.*, 744 F.3d 1199 (10th Cir. 2014)

Contingent Obligation in Stock Acquisition

Non-Consolidated Return Situations (Including S Corporation Target)

- If Target stock is sold, and contingent obligations remain with Target—
 - The obligations should be reflected as reduction in the price for the stock
 - Otherwise, in general there is no immediate tax effect to either Seller or Buyer and no special consequences when the obligations become due and are paid
 - Target deducts or capitalizes accrual and/or payment in accordance with usual tax accounting rules
- Under tax accounting rules, Target could have deferred tax on prepaid income for providing goods and/or services in the future (*see, e.g.*, Reg. §1.451-5; Rev. Proc. 2004-34, 2004-1 C.B. 991; *James M. Pierce Corp.* (Slide 32))
 - Unlike asset sale, stock sale ordinarily would not affect this deferral
 - The price for the stock should reflect both—
 - Target's contingent liability to provide the goods and/or services for which prepayment was made
 - Target's cost of deferred tax becoming due, usually when the Target provides the goods and/or services

Contingent Obligation in Stock Acquisition Consolidated Return Regulations—

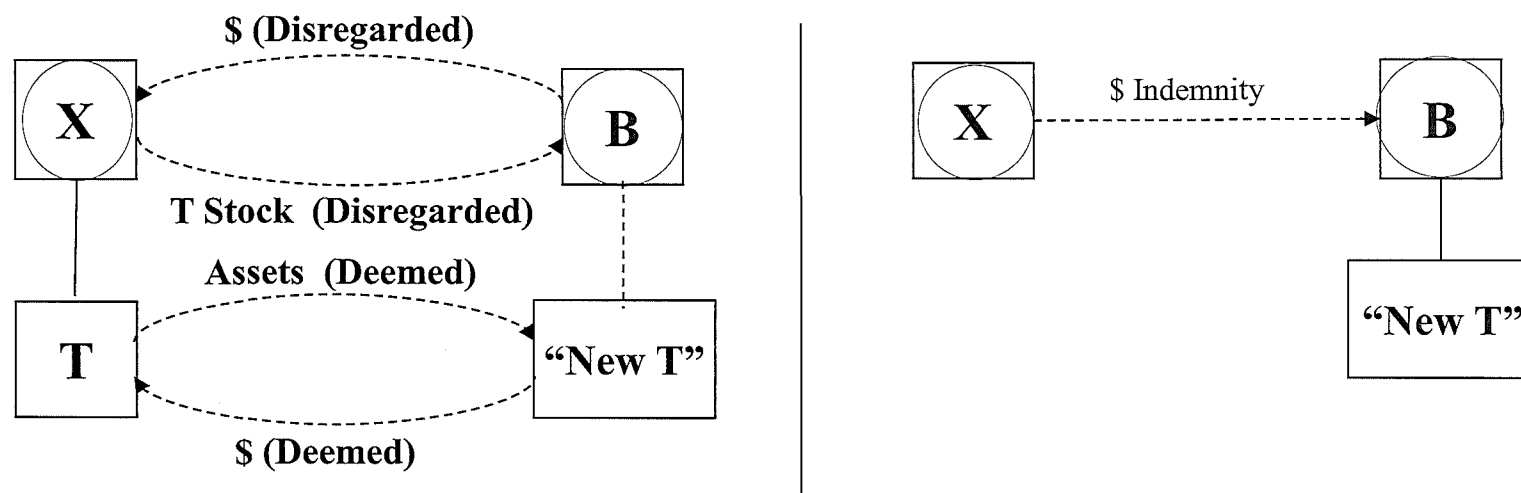
End-of-the-Day and Next-Day Rules; Circular Stock Basis Adjustments

- If Seller sells Target stock during a consolidated return year, planning is needed:
 - If the contingent obligation generates a deduction on the day of sale, either the Seller's group or the Buyer's group may claim the deduction, if the claim is reasonable, and the parties' treatment is consistent (Reg. §1.1502-76(b)(1)(ii); *but see* GLAM 2012-010 (deductions for exercise of stock options and SARs and for banker fees contingent on acquisition must be deducted by Seller's group; premium for retirement of target corporation bonds after acquisition may be deducted by Buyer's group))
 - If the obligation is for deferred compensation under §404(a)(5), the deduction may have to belong to Buyer's group
- If Seller's group claims the deduction—
 - Seller's basis in the Target stock is reduced (Reg. §1.1502-32), and its gain on the stock sale is increased (or its loss is reduced) by the same amount
 - If Target has a separate company loss for the year, this loss would seem to shelter gain on the sale of Target stock, but it would also reduce Seller's basis in the Target stock and so increase that gain
 - Thus \$1 gain on the Target stock could use, or "churn and burn" all of Target's loss
 - "Anti-churn-and-burn" rule (Reg. §1.1502-11(b)) prevents this result by prohibiting Target's loss from offsetting gain on a sale of Target stock
- If Buyer's group is entitled to the deduction, a loss limitation under §382(h) or a separate return limitation rule (SRLY) limitation may result.

Contingent Obligation in Stock Acquisitions
Consolidated Return Regulations
Unified Loss Rule—Loss Disallowance or Attribute Reduction

- If stock of consolidated Target is sold at a loss, the loss may be disallowed (Reg. §§1.1502-36(a)-(c))
- If the loss on the stock sale is allowed, Target's tax attributes (*e.g.*, loss carryovers or asset basis in excess of FMV) may be reduced after the sale to prevent double deduction (Reg. §1.1502-36(d))
 - If Target's "attribution reduction amount" (lesser of loss on stock sale or net inside built-in loss) is greater than the amount of Target's attributes available for reduction, and if Target has contingent obligations, the excess attribute reduction amount is suspended and applied to prevent Target from deducting or capitalizing a later accrual and/or payment of the contingent obligations (Reg. §1.1502-36(d) (4)(ii)(C))
 - This rule would apply if, *e.g.*, Target has a contingent obligation and holds cash to pay the obligation
 - The basis of the cash cannot be reduced
 - The loss otherwise could be duplicated when Target accrues and/or pays the contingent obligation and deducts payment or increases cost basis in an asset
 - Seller can prevent this rule from applying to Buyer by electing to reduce its stock basis, to reattribute Target's loss carryovers or deferred deductions, or both

Seller Indemnity for Contingent Obligation in Asset Sale or Stock Sale with §336(e) or §338(h)(10) Election Discussion Problem—Facts



- X owns all the stock of T, which owns a manufacturing business
- T is either a C corporation or an S corporation (If T is a C corporation, X is also a C corporation. If T is an S corporation, X is an individual)
- B is either a corporation, a noncorporate entity or an individual, unrelated to X
- X sells all the T stock to B for cash with election under §336(e) or (if B is a corporation) §338(h)(10)
 - At time of sale, T is the defendant in a patent infringement suit
 - X indemnifies B and T against an adverse judgment in the suit
 - Five years after closing, judgment is entered against T, and X pays the judgment

**Seller Indemnity for Contingent Obligation
in Asset Sale or Stock Sale with §336(e) or §338(h)(10) Election
Discussion Problem—Analysis—General**

- Because of election, sale of T stock is disregarded; T is deemed to sell its assets to New T; New T is deemed to assume T's liabilities; and T is deemed to liquidate (if T is a C corporation, tax-free under sections 332 and 337; if T is an S corporation, taxable under sections 331 and 336)
- If payment of the judgment by T would have been deductible to T without regard to the acquisition—
 - If T is a C corporation, X is entitled to deduct the payment as though no acquisition had occurred
 - If T is an S corporation, X's payment likely would be capital loss under *Arrowsmith*
- From the judgment and X's indemnity payment, neither B nor New T has taxable income or any net effect on basis of deemed purchased assets (basis increase for payment of judgment and offsetting reduction for indemnity payment, or no basis adjustment at all)

Flood v. United States (Slide 53)

Shannonhouse Estate v. Commissioner, 21 T.C. 422 (1953)

Rev. Rul. 75-154, 1975-1 C.B. 186

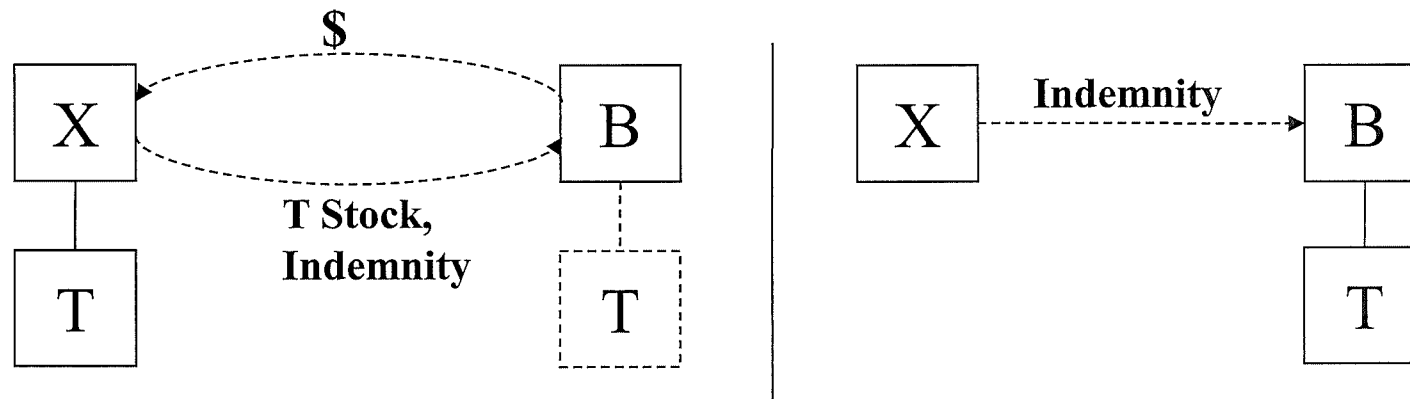
FSA 200048006, Aug. 14, 2000

Illinois Tool Works (Slide 36)

**Seller Indemnity for Contingent Obligation
in Asset Sale or Stock Sale with §336(e) or §338(h)(10) Election
Discussion Problem—Analysis—Tax Effecting X's Indemnity**

- Same facts as in Slide 46
- Under X and B's Stock Purchase Agreement, X's indemnity is reduced by any tax benefit to B or New T from the indemnified loss (*i.e.*, the judgment)
- X's indemnity could be viewed as either—
 - Assumption of obligation by X (not by New T) and payment by X of its own obligation (no deduction, asset basis increase or income to New T), or
 - Assumption of obligation by New T subject to contingent price adjustment (deduction or asset basis increase to New T, offset by income from indemnity payment)
- Either way, B and New T have no net tax benefit from the judgment against T and X's payment of the judgment
- Care should be exercised in drafting indemnity tax effecting provisions
 - Provisions should make clear whether intent is to make B and New T whole, to share any X tax benefit with B or some combination (*e.g.*, should B negotiate for X's indemnity payment to be increased by tax benefit of X's deduction for payment of judgment?)
 - If B and New T are to be made whole, provisions should state that tax effects of both the indemnified loss and the indemnity payment are taken into account

**Seller Indemnity for Contingent Obligation
in Stock Sale With No §336(e) or §338(h)(10) Election
Discussion Problem—Facts**



- X (C corporation or individual) owns all the stock of T (C or S corporation), which owns a manufacturing business
- T is defendant in a patent infringement lawsuit
- X sells the T stock to B for cash with no §336(e) or §338(h)(10) election
 - X agrees to indemnify B against an adverse judgment
 - Five years after closing, judgment is entered against T for damages
 - X pays the judgment

**Seller Indemnity for Contingent Obligation
in Stock Sale With No §336(e) or §338(h)(10) Election
Discussion Problem—Analysis—General**

- X is deemed to contribute its indemnity payment to T's capital, relating back to immediately before sale, and T is deemed to pay the judgment
 - Result is retroactive increase in X's basis in T stock
 - X is entitled to capital loss when its indemnity obligation accrues, and there is economic performance
 - T has no taxable income or gain
 - T deducts or capitalizes (in accordance with tax accounting rules) X's payment
 - No effect on B's basis in T stock
- Same analysis in tax-free reorganization

Estate of McGlothlin v. Commissioner, 370 F.2d 729 (5th Cir. 1967)

VCA Corporation v. United States, 566 F.2d 1192 (Ct. Cl. 1977)

Rev. Rul. 58-374, 1958-2 C.B. 396

Rev. Rul. 83-73, 1983-1 C.B. 84

GCM 38977 (April 8, 1982)

Seller Indemnity for Contingent Obligation
In Stock Sale With No §336(e) or §338(h)(10) Election
Discussion Problem—Analysis—Tax Effecting X's Indemnity

- Same facts as in Slide 49
- Under X and B's Stock Purchase Agreement, X's indemnity is reduced by any tax benefit to B or T from the indemnified loss (*i.e.*, the judgment)
- Since "tax effecting" of X's indemnity is by reference to B's and T's (not X's) tax situation, X's indemnity payment is reduced
 - T deducts payment of the judgment, even though made by X
 - T has no income or reduction in asset basis from X's payment of judgment
 - B has no income or reduction in T stock basis from X's payment of the judgment
- Care should be exercised in drafting indemnity tax effecting provisions:
 - Provisions should make clear whether intent is to make B and New T whole or to share any X tax benefit with B, or some combination (*e.g.*, should B negotiate for X's indemnity payment to be increased by tax benefit of X's capital loss for its payment of judgment?)
 - If B and New T are to be made whole, provisions should state that tax effects of both indemnified loss and indemnity payment are taken into account

Seller Indemnity for Contingent Obligation Sale of Partnership Interests

Facts

- T is an LLC taxable as a partnership. T has two members (“Sellers”), who have owned T for many years; T owns a manufacturing business and is the defendant in a patent infringement suit
- Sellers sell all the T membership (*i.e.*, partnership) interests to B for cash and realize substantial gains
- Sellers agree to indemnify B against any adverse judgment in the patent case
- Five years after closing, judgment is entered against T for damages, and Sellers pay the judgment

How do the consequences differ from those in Slide 49 (stock sale)?

- Sellers are treated as selling partnership interests, but B is treated as buying all the assets of T, which has become a disregarded entity (Rev. Rul. 99-6 (Sit. 2))
- Parts of Sellers’ gains likely are ordinary income under §751(a), and Sellers may have multiple types of capital gains under Reg. §1.1(h)-1
- P obtains a cost basis in the T assets

Seller Indemnity for Contingent Obligation Sale of Partnership Interests—Continued

- When Sellers pay the judgment against T, does the payment result in a loss of the same character(s) as the gains on the sale of the partnership interests under *Arrowsmith*, or do they have ordinary losses as former partners incurring a deductible liability of the partnership business? (*Flood v. United States*, 133 F.2d 173 (1st Cir. 1943) (payments of pension obligations by partners to former partnership employees deductible, even though partnership assets had been sold and partnership had been liquidated))
- When Sellers pay the judgment against T, a disregarded entity, does the payment result in (1) income to B and additional basis in the purchased assets, (2) income to B with an offsetting deduction, or (3) no tax consequence to B?