2014

Contingent Consideration, Contingent Liabilities and Indemnities in Acquisitions (Outline)

Robert H. Wellen

CONTINGENT CONSIDERATION, CONTINGENT LIABILITIES AND INDEMNITIES IN ACQUISITIONS

OUTLINE
REFERENCES

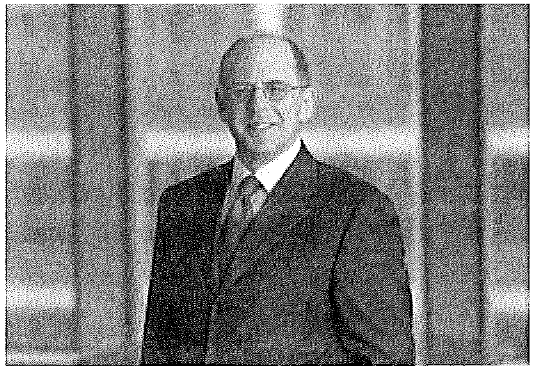
WILLIAM AND MARY TAX CONFERENCE
NOVEMBER 6-7, 2014

KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA

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

SEPTEMBER 2014

THIS PAGE INTENTIONALLY LEFT BLANK



ROBERT H. WELLEN
IVINS, PHILLIPS & BARKER
WASHINGTON, D.C.
Direct phone: 202-662-3401
Email: rwellen@ipbtax.com

LAW PRACTICE

Bob Wellen has practiced tax law for almost 40 years. His practice includes planning and negotiating corporate acquisitions, joint ventures, financings, equity offerings and spin-offs and developing corporate structures. Regarding these types of matters, he obtains IRS advance rulings; represents taxpayers in administrative tax controversies and litigation and advocates policy positions before the Treasury Department and IRS. He also serves as an arbitrator in commercial cases involving tax issues, such as tax sharing agreements, and as an expert witness on tax issues.

EDUCATION

Bob received his B.A. from Yale College (magna cum laude, Phi Beta Kappa) in 1968, his J.D. from Yale Law School in 1971 and his LLM (Taxation) from Georgetown University Law Center in 1974.

CAREER

Bob served on active duty in the U.S. Navy Judge Advocate General's Corps. Thereafter, he joined Fulbright & Jaworski (now Norton Rose Fulbright) in 1975 and became a partner in that firm in 1979. He joined Ivins, Phillips & Barker as a partner in 1993.

PUBLICATIONS

Bob has written numerous articles for tax publications, including the Practising Law Institute proceedings, TAXES, Tax Notes and The Journal of Taxation. He lectures frequently at professional education programs, including programs sponsored by the American Bar Association, the Practising Law Institute, the American Law Institute, the Tax Executives Institute, the Federal Bar Association, the District of Columbia Bar, New York University, University of Chicago, Penn State University/ Dickinson College of Law, University of California at Los Angeles, University of Miami, William & Mary Law School and the Southern Federal Tax Institute.

PROFESSIONAL ASSOCIATIONS

Bob is a member of the American Bar Association Tax Section, in which he served as chair of the Corporate Tax Committee. He is also a fellow of the American College of Tax Counsel and a member of the District of Columbia Bar Tax Section and the Federal Bar Association.

THIS PAGE INTENTIONALLY LEFT BLANK

CONTINGENT CONSIDERATION, CONTINGENT LIABILITIES AND INDEMNITIES IN ACQUISITIONS

OUTLINE

WILLIAM AND MARY TAX CONFERENCE
NOVEMBER 6-7, 2014
KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA

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

SEPTEMBER 2014

TABLE OF CONTENTS

Page

CONTINGENT CONSIDERATION, CONTINGENT LIABILITIES AND INDEMNITIES IN ACQUISITIONS

OUTLINE

WILLIAM AND MARY TAX CONFERENCE
NOVEMBER 6-7, 2014
KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA

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

SEPTEMBER 2014

NOMENCLATURE

AFR	=	Applicable Federal Rate as determined under section 1274(d)
Acquiror	=	Purchaser of assets from Seller; or purchaser of Target stock (with or without election under section 338(h)(10) or section 336(e)) from Seller; or corporation acquiring Target stock or assets in a tax-free reorganization.
Closing	=	Effective date of a transaction for tax purposes.
Parent	=	Parent corporation of a corporate Acquiror.
Seller	=	Seller of assets of Target's business or seller of Target stock (with or without election under section 338(h)(10) or section 336(e)).
Target	=	Corporation whose stock is sold to Acquiror (with or without election under section 338(h)(10) or section 336(e)); or corporation whose stock or assets are acquired by Acquiror in a tax-free reorganization.
Old T	=	Deemed seller of assets to New T in a stock sale subject to election under section 338(h)(10) or section 336(e).
New T	=	Deemed purchaser of Target assets from Old T in a stock sale subject to election under section 338(h)(10) or section 336(e).

INTRODUCTION

All business acquisitions have loose ends. Acquiror may agree to pay contingent consideration for the acquired business, like an earn-out, or part of the consideration may be placed into escrow. More often, at the time of Closing it is not possible to identify and quantify all the costs incurred in the business and all the claims that may be asserted against the business. Open items might include costs for environmental remediation, deferred compensation and other employee benefits (vested or non-vested), tax deficiencies, product liabilities, warranty claims, contract claims or tort claims. Acquiror may assume the obligation to pay these costs and claims, or Seller to the obligee, may be financially responsible for their obligations, directly, through indemnities, or both. This outline discusses the tax consequences of these loose ends.

The law in this area contains a number of surprises and uncertainties. As examples –

- If Acquiror agrees to pay contingent consideration for business assets, the tax treatment of Seller and Acquiror are not consistent. Unless Seller elects the installment method or is eligible for the "open transaction" method, Seller must use the "closed transaction" method and include the estimated present value of future contingent purchase price payments in its amount realized at Closing. Regardless of how Seller reports the sale, however, Acquiror may not deduct these payments, or even include them in the basis of the purchased assets, until the amounts become fixed and determinable and are paid. Even then, it's likely that Acquiror will have to capitalize these payments and allocate them among the purchased assets – probably to goodwill with 15-year amortization, beginning at Closing prorated from the time of accrual.
- Under regulations in effect until 2000, a consolidated group or S corporation shareholders that sold a business generally was better off selling stock and making a section 338(h)(10) election, as opposed to having the corporation actually sell its assets. In an asset sale, Seller generally had to report a closed transaction, but in a stock sale with a section 338(h)(10) election Seller and Target could use the open transaction method and delay reporting the contingent purchase price until received. The only disadvantage of a section 338(h)(10) stock sale was that Seller could not use the installment method.
- Under current regulations, in a section 338(h)(10) or section 336(e) stock sale, Target is treated as though it had actually sold assets. As in an actual asset sale, the closed transaction method is the paradigm but the installment method is available.
- In either an actual asset sale or a section 338(h)(10) or section 336(e) stock sale, the open transaction method is available, but only in "rare and extraordinary" cases. This method allows all the basis of the assets sold, or deemed sold, to be recovered against the first sale proceeds received, so that taxable gain is deferred with all the basis is recovered.
- Under the open transaction method, losses are deferred until all contingent consideration is received. Thus, the presence of loss and gain assets in the same transaction can cause distortion where this method is used.
- The open transaction method appears to be available for assumed contingent liabilities where the requirements for the open transaction method are met.
- Under the closed transaction method, if Seller is entitled to contingent consideration, it must report the estimated present value of the contingent consideration as amount realized at Closing. If Seller receives more or less than this estimated amount, it is not clear whether the difference (apart from imputed interest) is ordinary income or loss or capital gain or loss, but ordinary income or loss treatment is likely.

- Under the closed transaction method, if Acquiror assumes contingent liabilities, Seller likely is required to add to its amount realized at Closing the present value of the assumed liabilities.
- The installment method often results in less tax deferral to Seller than one might suppose, due to asset basis being recovered against payments to be received in the future.
- It is unlikely but possible that Acquiror will recognize taxable income at Closing to account for contingent liabilities assumed by it, with offsetting increase in asset basis and perhaps a deduction when the liabilities become fixed and are paid.
- Under proposed regulations published in 1999, in a taxable acquisition if part of the purchase price is placed into escrow, Acquiror would be taxed on income earned on the escrowed funds until it is determined which party will receive the funds. Acquiror would be taxed on this income even if the income is actually paid to Seller out of the escrow. If a dispute develops, and the funds come under court jurisdiction, then, under final regulations, the escrow fund is taxed as a separate entity.
- On the other hand, escrowed Acquiror stock in a tax-free reorganization is considered to belong to the former Target shareholders, and any dividends paid on the escrowed stock are taxed to those shareholders as dividends.
- In a tax-free reorganization with contingent stock (as opposed to escrowed stock), imputed interest is taxed to the former Target shareholders and is deductible to Acquiror. However, dividends on the contingent stock are not taxed to the former Target shareholders if not actually paid to them.
- Payment of assumed liabilities by Acquiror may result in additional taxable gain from the sale and offsetting deductions to Seller. These deductions may or may not be available, however, at the same time as the gain recognition. The lack of guidance on this point makes planning difficult and requires Seller to continue to follow the fortunes of the sold business, even if Seller is not liable for contingent liabilities.
- Acquiror must capitalize rather than deduct many post-Closing expenditures relating to a business it has acquired, including some that seem routine or result from surprises after Closing. If Acquiror's obligation to make these expenditures is contingent at Closing, Acquiror is not allowed depreciation deductions for these capitalized amounts until the all-events test and the economic performance tests are met (usually when payment occurs).
- In a taxable stock sale without a section 338(h)(10) or section 336(e) election, if Target has contingent liabilities that Seller retains (*e.g.*, through indemnities), two deductions may result—a capital loss to Seller and an ordinary deduction to Target—with no offsetting income or gain to Acquiror, Seller or Target.
- If a loss (even a real economic loss) is recognized on a sale of stock (without a section 338(h)(10) or section 336(e) election) of a Target that is a subsidiary in a consolidated group, Target's tax attributes (loss carryovers, asset basis, etc.) may be reduced after the sale to prevent duplication of tax benefits. Acquiror will bear this burden. If the loss is due to a contingent liability paid after the stock sale, the tax attributes are reduced when the liability is taken into account, or the payment of the liability itself may become non-deductible.

- Contingent liabilities may affect whether an acquisition can qualify as a tax-free reorganization. If Target's contingent liabilities are large enough so that, together with fixed liabilities, the amount of liabilities is greater than the fair market value of its assets, then, under proposed regulations, no tax-free reorganization would be possible. The proposed regulations do not, however, explain how to compute Target's contingent liabilities for this purpose. The same rules would apply to asset transfers to corporations under sections 351 and corporate dissolutions under section 332.

TAXABLE ASSET AND STOCK ACQUISITIONS

I. Contingent Purchase Price in Acquisitions of Target Assets or Stock

A. Treatment of Seller – Choice Between Installment Method and Election Out

The Seller of assets or Target stock in a taxable acquisition with contingent purchase price reports gain (but not loss) on the installment method unless Seller elects out. For a summary of the advantages and disadvantages of the installment method, *see* part I.B.6., below.

B. Treatment of Seller – Installment Method

1. Installment Method – Application

Installment method reporting applies to gain on a sale with contingent purchase price if at least one payment is to be received after the taxable year of the Closing. But the installment method does not apply to losses, which must be taken in the year of Closing, under the closed transaction method, or later if the open transaction method is used. *See* part I.C.3., above. Sales of certain property, such as inventory, publicly traded securities and depreciable property to the extent of recapture, are also ineligible for the installment method. Sections 453(f)(2), (f)(7). Thus, installment method reporting requires an asset-by-asset determination on applicability. It is possible that an assumption by Acquiror of contingent liabilities, without more, makes a sale eligible for the installment method. *See* part IV.D., below.

2. Installment Method – Election Out

If a sale is eligible, installment method reporting is automatic unless Seller elects out. Election out of the installment method is irrevocable except with IRS consent. Similarly, Seller may not elect out after filing its original return except for good cause with IRS consent, to be granted only in "rare circumstances." Reg. § 15a.453-1(d)(3)(ii). But in *Mamula v. Commissioner*, 346 F.2d 1016 (9th Cir. 1965), the taxpayer, following his accountant's advice, reported a sale under the open transaction method. After IRS disallowed the open transaction method, the taxpayer elected the installment method after the fact, but IRS refused to consent. The court held that IRS could not refuse to allow taxpayer to elect installment method, because the method he had chosen was not permissible (distinguishing *Pacific National Co. v. Welch*, 304 U.S. 191 (1938), in which a late installment method election was not allowed, but the original method was permissible).

3. Installment Method – Method of Calculating Gain Recognized

a. General

If the installment method is used, gain is recognized as Seller receives each payment. Generally, the amount of gain allocable to each payment is determined under section 453(c) by allocating basis in proportion to the amounts of principal payments to be received. The treatment of a contingent payment under the installment sale rules depends on whether the contingent payment is limited as to amount, as to timing, or neither. Commonly there is a cap on the amount of the contingent payments. In this case, basis recovered against each payment is computed as though the maximum amount were to be received at the possible earliest date. If payments of contingent liabilities by Purchaser are considered part of the purchase price, the installment sale method would apply and force delay in Seller's recovery of a portion of its basis until the payments are received. The open transaction method generally is more favorable than the installment method, because the open transaction method avoids valuation problems and permits delaying taxable gain until all basis has been recovered. Under prior section 338 regulations in effect until 2000, the open transaction method was readily available for contingent consideration (including but not limited to assumption of contingent liabilities) in the context of a stock sale with a section 338(h)(10) election, but the current section regulations eliminate this advantage. *See* parts II.B.2.a., II.B.2.b. and II*.A.2., below.

b. Amount Realized at Closing

Unless Seller elects out, receipt of Acquiror's installment obligation does not constitute a taxable event or a "payment" of an installment, irrespective of Seller's overall method of accounting. *See* part II.B.1., below, for discussion of the installment sale method in section 338(h)(10) or section 336(e) stock sales.

c. Amount Realized Upon Receipt of Payment

To the extent payments are received at Closing or later, Seller reports as gain the amount by which the payment (excluding interest) exceeds the allocable portion of the basis of what is sold. The amount of gain recognized at the time of each payment is the proportion of the payment that the "gross profit" (over the entire life of the contract) bears to the "total contract price." Section 453(c). If no interest is stated, payments received are considered to include interest at the AFR. Reg. §§ 1.1274-1(b), 1.1274-4. Thus, Seller reports gain on the principal portion of contingent payments discounted to the date of sale using the AFR (or higher interest rate in the purchase agreement). The rest of the payment is taxable as interest income.

d. Allocation of Amounts Realized Among Assets Sold

In an asset sale, the total selling price, including the contingent payment obligation, is allocated among the assets sold, tangible and intangible, under the residual method described in Reg. § 1.1060-1. But different forms of consideration may be specially allocated. *See* part I.B.4., below.

(1) Increases in Purchase Price

Under section 1060, increases in Seller's consideration received (amount realized) are allocated among the assets sold under the residual method. Reg. §§ 1.338-6(b) and 1.338-7, cross - referenced in Reg. § 1.1060-1(c)(2). The same treatment applies to payments by Acquiror of assumed contingent liabilities that are treated as purchase price adjustments. This treatment seems to mean that every acquisition of a business with contingent liabilities is an installment sale. *See* part IV.D., below.

(2) Decreases in Purchase Price

Decreases in consideration received by Seller are allocated in reverse section 1060 order: first to goodwill (Class VII), then to other intangibles (Class VI), etc. Reg. §§ 1.338-6(b) and 1.338-7, cross referenced in Reg. § 1.1060-1(c)(2). However, the IRS position is that no refund of section 453A deferral charge is allowed. *See* part I.B.5.c., below. An example of a decrease in purchase price is an indemnity payment made by Seller to Acquiror for a breach of a covenant, warranty or representation. *See* parts V.D. and V.E., below.

e. Recovery of Asset Basis

In most cases, contingent purchase price arrangements are limited by total amount, by time, or both. Basis recovery depends on which, if either, of these limitations applies.

(1) Maximum Selling Price

If the total amount of the contingent consideration is subject to a cap, then, for purposes of allocating basis among payments, the cap is assumed to be the selling price. Reg. § 15a.453-1(c)(2)(i). That is, it is assumed that all contingencies will be resolved to maximize the selling price and accelerate payments to their earliest possible date. Because this method defers basis recovery and accelerates gain, it may not be in Seller's interest, from a pure tax viewpoint, to negotiate a cap much above the amount of payments it is likely to receive. If later events reduce the maximum price, it can be recomputed. Reg. § 15a.453-1(c)(2)(i)(A). If this re-computation results in a loss, Seller reports the loss on the sale at the time of Closing. Reg. §§ 15a.453-1(c)(2)(iii) Example (5), 15a.453-1(c)(3)(i).

(2) Time Limitation

If no maximum selling price can be determined, but the contingent payment is limited to a specified time period, basis is generally 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, no loss is allowed. Instead the amount of unrecovered basis is carried forward to the following year. Reg. § 15a.453-1(c)(3). *Cf. Schmidt v. Commissioner*, 55 T.C. 335 (1970) (no loss to shareholder on corporate liquidation until complete).

In *ACM Partnership v. Commissioner,* T.C. Memo 1997-115, *aff'd* 157 F.3d 231 (3d Cir. 1998), *Saba Partnership v. Commissioner*, T.C. Memo 1999-359 (1999), *ASA Investerings Partnership v. Commissioner*, T.C. Memo 1998-305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *Boca Investerings Partnership v. United States*, 314 F.2d 625 (D.C. Cir. 2003), and *Andantec, L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), the taxpayers tried to take advantage of the ratable basis recovery under these regulations with respect to debt instruments purchased and sold in multiple party financing arrangements through partnerships. The sales produced losses for certain partners in the later years of the fixed recovery period. In *ACM,* the Tax Court and the Third Circuit both held the transaction to be a sham in substance and denied the loss. The Tax Court followed the same reasoning in *Saba.* In *ASA*, the emphasis was on the lack of a true partnership, but the loss was still disallowed. In *Boca*, the district court distinguished the other cases and held that the contingent installment sale was not a sham, but the court of appeals reversed and held that the installment sale should be disregarded as a sham as a matter of law.

(3) No Maximum Selling Price or Time Limitation

If contingent payments are not limited by either a cap or a fixed period, the transaction is analyzed to determine whether, in substance, a sale occurred, and whether the purported installment obligation is a debt from Acquiror to Seller or an equity stake in Acquiror or Target.

See part I.G., below. If the purported installment obligation qualifies as such, basis generally is recovered ratably over 15 years. Reg. § 15a.453-1(c)(4).

No loss is recognized until the transaction is completed. Basis in excess of the amount of a payment in any given year is carried forward to future years until it is applied against proceeds, or the future payment obligation is determined to be worthless. Reg. § 15a.453-1(c)(4).

(4) Alternative Methods of Basis Recovery

Seller may request a ruling that the general basis recovery rules would inappropriately defer recovery of its basis. The test is whether the straight-line allocation "would substantially or inappropriately defer or accelerate" recovery. Reg. § 15a.453-1(c)(7)(ii).

Similarly, IRS may defer basis recovery if it determines that the general rules inappropriately accelerate recovery. Reg. § 15a.453-1(c)(7)(iii).

(5) Impact of Loss Assets, Etc.

Losses are not deferred under the installment method. Nor are gains on sales of inventory, depreciation recapture, etc.

(6) Impact of Assumed Contingent Liabilities

If Acquiror assumes contingent liabilities in an asset purchase, the assumption is probably contingent purchase price that would invoke the basis recovery rules of the installment sale method. *See* parts II.B.1.b. and IV.D., below. For example, if Acquiror assumes Seller's contingent liabilities with no cap or time limit, it appears that Seller must recover its asset basis over 15 years, unless it either receives IRS permission to do otherwise or elects out of the installment method.

f. Character of Amounts Realized – Actual and Imputed Interest

Payments received are subject to imputed interest under section 483 or section 1274, unless the parties specify that the payments include interest at a rate at least equal to AFR. Reg. § 15a.453-1(c)(2)(ii). Actual or imputed interest is separately includible to the Seller when received and deductible to Acquiror when paid. There is no original issue discount income or deduction.

4. Allocating Installment Obligation to Certain Assets

Seller may be able to allocate contingent consideration to assets on which the installment method would provide the most benefit—*e.g.*, allocate contingent consideration to goodwill and going concern value (which may have a zero basis) and the cash portion of the purchase price to tangible assets, or contingent consideration to gain assets and cash to loss assets. *Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq*. 1964-2 CB 6; Rev. Rul. 68-13, 1968-1 CB 195. This ability to recover more basis against cash received at Closing would make the installment method more attractive. *See* part I.C.3.c.(2), below, for discussion of possible benefit of allocating contingent consideration to inventory, which cannot be sold under the installment method.

In PLR 200004040 (Oct. 24, 1999), IRS suggested that, in an asset purchase under section 1060, different forms of consideration may not be allocated to different assets in an acquisition. The ruling states that consideration should be treated as paid for the assets as a whole and allocated solely by reference to the scheme described in the regulations for sections 338 and 1060, *i.e.*, class by class. In LAFA 20080101F (Dec. 3, 2007), IRS cited an earlier version of this outline in support of a conclusion that *Monoghan* and Rev. Rul. 68-13 do not authorize fragmenting a sale of a business into separate installment sales with differing gross profit ratios. The author generally agrees with this conclusion in abusive situations such as the one involved in LAFA 20080101F. In the author's view, however, *Monoghan* and Rev. Rul. 68-13 generally do allow allocation of an installment note to some assets and cash or other consideration to other assets.

Finally, if such allocation is allowed in an actual asset sale under section 1060, it is still not clear whether different forms of consideration can be allocated among different assets in a stock sale with an election under section 338(h)(10) or section 336(e). The applicable regulations provide detailed rules for allocating amounts of consideration to determine Old T's gain or loss on the deemed asset sale New T's basis in the assets deemed purchased by it. *See* part II.A.3., below. There are no rules, however, dealing with allocating types of consideration among the assets. The only guidance is the general principle, stated in Reg. § 1.338-1(a)(2):

> Other rules of law apply to determine the tax consequences to [Old T and New T] as if [Old T and New T] had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except as otherwise provided in those regulations.

This general principle suggests that *Monoghan* and Rev. Rul. 68-13, like other rules of law applicable to asset sales, applies to the deemed asset sales under sections 338(h)(10) and 336(e), at least to the same extent as in actual asset sales.

5. Installment Method – Deferral Charge

a. General

If the sale price reported under the installment method in one transaction is greater than $150,000, and if Seller has more than $5,000,000 deferred gain from one or more installment sales, Seller is subject to an interest-type deferral charge at the underpayment rate (Federal short-term rate plus three percentage points). Section 453A. Because of this high interest rate and the way the deferral charge is computed, in a large transaction Seller usually obtains little or no advantage from the time value of tax deferral under the installment method.

b. Mechanics

(1) Computations

The deferral charge is calculated by first determining the "applicable percentage," which is (i) the portion of the aggregate face amount of all installment obligations arising in a taxable year in excess of $5,000,0000, divided by (ii) the aggregate face amount of such obligations outstanding as of the close of the taxable year.

For individuals, the deferred tax liability is this amount of deferred gain multiplied by the maximum rate under section 1(h) (currently 28%), even though this rate does not apply to most long-term capital gains. Finally, the deferred tax is multiplied by the underpayment rate in effect at the end of the taxable year. That is the deferral charge for each year. The deferral charge is not deductible to individual taxpayers.

For corporations, the deferral charge is computed in the same manner as for individuals, except that the tax rate used is the maximum rate under section 11 (currently 35%). The deferral charge is deductible to corporations.

(2) Application to Contingent Purchase Price

For taxpayers who dispose of property in an installment sale with a contingent sale price and use the installment method, section 453A(c)(6), enacted in 1980, provides:

> The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subsection including regulations providing for application of this subsection in the case of contingent payments...

Treasury has provided no published guidance on calculating the deferral charge on contingent sale price installment obligations. In CCA 201121020 (May 27, 2011), IRS stated:

> In the absence of regulations under § 453A(c)(6), the Service allows taxpayers to use a reasonable method of calculating the deferred tax and interest on the deferred tax liability with respect to contingent payment installment obligations.

One possible approach would be to substitute the fair market value of the contingent payments as of the Closing date for the face amount of the installment obligations in the formula. If the fair market value of the contingent payment obligations held by the taxpayer is $5,000,000 or less, no deferral charge would be payable. As contingent deferred payments are received in future years and gain is recognized, Seller would calculate the deferral charge by reducing previous fair market value by the amount of deferred payments (less imputed interest) that had been recognized through the tax year for which the deferral charge is being calculated. This method would place a Seller who reports on the installment method in an economic position similar to the position of one who elects out of the installment method and uses the closed transaction method. For this reason, it seems to be a reasonable method of applying the deferral charge. In TAM 9853002 (Jan. 4, 1999) (discussed in part I.B.5.c., below), IRS identified parity with the closed transaction method as Congress's primary objective in enacting the deferral charge.

Another possible approach is identified in LAFA 20080101F (Dec. 3, 2007) as the "look back" method. Here, Seller would wait until deferred payments are received and compute the deferral charge as though the amount ultimately received (net of imputed interest) were the face amount of the installment obligation. Because this method defers the deferral charge until payments are received, the taxpayer presumably would pay interest on the deferral charge itself, but the LAFA does not spell out such details. This method would not be in parity with the closed transaction method. Instead, it would have the effect of adding a deferral charge to an open transaction.

c. TAM 9853002 and its Implications

(1) TAM 9853002 Described

In an installment sale involving contingent purchase price, Seller may have to pay a deferral charge on gain from purchase price that is never received. In TAM 9853002 (undated), Seller sold a business for a contingent note based on cash flow from the business. In reporting its deferred gain under section 453A, Seller estimated that it would receive the maximum earn-out and paid section 453A deferral charges based on this amount. Market conditions deteriorated, however, and Seller received less than the maximum earn-out. Seller amended its return for the year of Closing to claim a refund of the deferral charge. IRS denied the refund, based on the conclusion that Seller may not adjust its deferral charge retroactively. Reg. § 15a.453-1(c)(7), which allows alternative basis recovery, did not apply, because this regulation allows adjustments to timing, not amounts, of income. In addition, Seller did not request an advance ruling before filing its original return for the year of the sale, as the regulations require.

(2) Rationale

The result in TAM 9853002 seems harsh, but, as the TAM points out, no more than if Seller elects out of the installment method and, in a closed transaction, includes the contingent payment right in its amount realized at Closing. There, Seller would pay its tax based on the fair market value of the contingent payment right at Closing and recognize a loss later but would not be entitled to interest on the excess tax paid for the year of Closing. *See* part I.C.2., below.

(3) Maximum Selling Price or Fair Market Value?

Suppose Seller concludes that the fair market value of the contingent payment right is less than the discounted present value of the maximum amount (*i.e.*, Seller expects to receive less than the maximum amount). In a non-installment sale, Seller's amount realized is determined by the fair market value of the contingent payment right, not its maximum amount. In an installment sale, however, it is not clear whether the calculation of gain contemplates fair market value or maximum amount. TAM 9853002 is inconclusive because in that case Seller concluded that fair market value was equal to maximum amount. FSA 199941001 (Feb. 2, 1999) states that a Seller who used the fair market value of the contingent payment right had calculated gain correctly but also argues in the alternative that the maximum amount might have been appropriate. The policy that favors similar treatment of taxpayers in equivalent situations argues for fair market value. If the deferral charge is based on the fair market value of the contingent payment right, there is parity between installment and non-installment situations. But if the deferral charge were based on the maximum amount of the contingent payment right, installment sales would be taxed more heavily(on a percent value basis) than non-installment sale. *See* also LAFA 20080101F (Dec. 3, 2007).

d. Possible Future Guidance

The most recent Priority Guidance Plan lists "Regulations under §453A regarding contingent payment sales" as an open project. Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Tax Accounting ¶ 14

6. Advantages and Disadvantages of Installment Sale Method to Seller

a. Advantages

Installment method reporting may benefit Seller, especially in a small transaction ($5,000,000 or less), by permitting deferral of gain. If Seller anticipates receiving only small amounts in the early years of a fixed period, the benefits can be significant, because the basis recovery rules are unlikely to accelerate gain. In larger transactions, Seller is unlikely to get much if any advantage from the installment method, mainly because of the deferral charge discussed in part I.B.5., above.

Another advantage of the installment method is the guaranteed capital gain treatment. This guarantee contrasts with the closed transaction method, in which, if Seller underestimates the value of the right to contingent purchase price, the excess is likely to be taxed as ordinary income. *See* part I.B.2., above.

b. Disadvantages

The biggest disadvantage of the installment method is the section 453A deferral charge for total obligations held by Seller greater than $5,000,000. The deferral charge can be especially onerous for individuals, due to use of a 28% assumed tax rate, the floating underpayment interest rate and non-deductibility of the deferral charge. Even worse, if interest rates increase after Closing, there is not even a mechanism to terminate accretion of deferral charges by paying the tax.

Even in a transaction that does not generates a deferral charge, Seller may find the installment method disadvantageous. This would occur, for example, if the maximum selling price considerably exceeds the amount actually paid after resolution of the contingencies, causing basis recovery to be delayed (*but see* part I.B.3., above).

In view of these disadvantages, there may not be much benefit to installment reporting over closed transaction treatment, and open transaction treatment is often much more beneficial.

C. Treatment of Seller – Consequences of Electing Out of Installment Method

1. Timing and Character of Amount Realized

a. General Rule: Closed Transaction Method

If Seller elects out of the installment method, Seller usually must use the closed transaction method and include the fair market value of the right to contingent payments in its amount realized at Closing. Reg. § 1.1001-1(g)(2). In TAM 9853002 (undated), IRS compared this result to the results under the installment method, taking the deferral charge of section 453A into account. IRS concluded that the results under the installment sale method and the closed transaction method should be economically comparable. *See* part I.B.5.c., below.

In determining the fair market value of the right to contingent purchase price payments, restrictions on transferability of the right to receive the payments are disregarded, and the value of the right to receive the payments cannot be less than the fair market value of the property sold less other consideration received. Reg. § 15a.453-1(d)(2)(i) and (ii). Compare section 7701(g) (in determining gain or loss on sale of property, the fair market value of the property may not be treated as less than the amount of nonrecourse debt to which the property is subject).

b. Exception: Open Transaction Method

Based on *Burnet v. Logan*, 283 U.S. 404 (1931), the regulations permit Seller to use the open transaction method—and to wait and see before recognizing gain—only "in rare and extraordinary cases" in which the fair market value of the contingent payments is not "reasonably ascertainable." Reg. § 1.1001-1(g)(2)(ii). Open transaction treatment means no amount is realized until either (i) payment is received (cash method taxpayers), or (ii) all events occur which fix the right to receive the payment, and the amount can be determined with reasonable accuracy (accrual method taxpayers). Apart from imputed interest, amounts received are applied first against asset basis, deferring gain recognition until all basis is recovered. Loss is not recognized, however, as long as the transaction remains open.

2. Closed Transaction Method

a. Closed Transaction Method – Principal Amount

The theory of Reg. § 1.1001-1(g)(2) is that, at Closing, as the amount realized for its assets, Seller receives the fixed purchase price plus a separate item of property—the right to contingent payments in the future. Seller is to report at Closing the fair market value of its right to future contingent purchase price payments and take basis in the contingent payment right equal to this amount. As contingent payments are received, they are allocated between principal and interest under section 1274 or section 483, whichever applies. *See* parts I.C.2.b. and c., below. The amounts allocated to principal are tax-free return of capital up to the basis of the contingent payment right. (That is, the basis in the principal obligation is not allocated among payments as in an installment sale). Any excess of contingent principal payments over basis is gain. If the contingent principal payments add up to less than the basis when the right expires, the excess basis is a loss.

b. Closed Transaction Method – Principal and Interest – Section 1274

No original issue discount accrues before payments are made or accrued. Instead, when payments are made, Seller discounts the payments under section 1274 to present value at the date of sale to determine the principal and interest portions of the payment. Reg. § 1.1275-4(c)(4)(ii). The parties may state an interest rate, so long as that rate is equal to or greater than the AFR. Otherwise, AFR is used to compute imputed interest.

c. Closed Transaction Method – Principal and Interest – Section 483

Similar rules for allocating payments between principal and interest apply if the obligation is subject to section 483. Here again, interest is imputed but is taxed only when received. Section 483 generally applies to small transactions and other specifically-designated situations. More relevant here, section 483, not section 1274, applies to contingent debt before it becomes fixed, so that during this time interest accretes but is not taxable to Seller or deductible to Acquiror until the contingency becomes fixed. Reg. §§ 1.483-4, 1.275-4(a)(2)(i). Section 483 also applies to contingent stock received in tax-free acquisitions. *See* part VIII.D., below.

d. Closed Transaction Method – Principal Amounts – Character of Gain or Loss – Stakes

Is the gain or loss on the contingent purchase price payment right ordinary income or capital gain? The answer can be important, especially if there is gain at Closing but loss when the contingent payment right expires (because the contingent payments received amount to less than the value of the right to receive the payments at the Closing date). If the loss on the contingent payment right is capital loss, and if this loss is recognized more than three years after the Closing (five years, for losses recognized in 2001 and 2002), it cannot be carried back to shelter any capital gain on the asset sale. Thus, the loss could become unusable unless Seller has other capital gains.

e. Closed Transaction Method – Principal Amounts – Character of Gain or Loss – Possible Analyses

(1) Adjustment to Purchase Price

One might assume that gain or loss from contingent purchase price payments being higher or lower than expected has the same character as the gain or loss on the underlying sale of the business (usually capital gain or loss). Such a result would be based on the idea that this gain or loss is an adjustment to the price in the underlying sale. *Commissioner v. Arrowsmith*, 193 F.2d 734 (2d Cir. 1952). This adjustment-to-purchase-price approach is not, however, consistent with the closed transaction concept of Reg. § 1.1001-1(g)(2)(ii). In the original section 338 regulations (Old Reg. § 1.338(b)-3T(c), discussed in part II*.A.2., below), all contingent payments (not just the gain or loss on the right to contingent payments) were treated as purchase price adjustments in a true open transaction method. The current regulations reject this approach, however, and simply treat stock sales with elections under section 338 or section 336(e) in the same manner as actual asset sales. *See* part II.B.2.b., below.

(2) Closed Transaction

Under the closed transaction rules of Reg. § 1.1001-1(g)(2)(ii), the value of Seller's right to contingent purchase price payments is included in the amount realized on the sale at Closing and that value is the basis of that right in Seller's hands. If Seller receives contingent purchase price payments greater or less than this amount (excluding imputed interest), the difference is gain or loss to Seller. To determine the character of the gain or loss, there are two ways to look at this right: a "debt instrument" under section 1271(a) or a contract right subject to extensive and conflicting case law and IRS rulings.

f. Closed Transaction Method – Principal Amounts – Character of Gain or Loss – Contingent Purchase Price Payment Right as Debt Instrument

(1) Gain

Section 1271(a) was enacted in 1984 to treat a borrower's repayment of its own "debt instrument" as a "sale or exchange" by the holder. The purpose was to eliminate the distinction in the case law between sales and repayments and the opportunity to convert a holder's capital loss into an ordinary loss or to convert ordinary income into capital gain. *Fairbanks v. United States*, 306 U.S. 436 (1939). Thus, under section 1271(a), if Seller's right to contingent purchase price payments is a "debt instrument," gain resulting from contingent payments received above the fair market value of the right at Closing (*i.e.*, the amount actually realized less the basis of the right) would be capital gain. Section 1271(a) is part of the gradual narrowing of the "extinguishment doctrine," discussed in part I.C.2.g.(3), below.

(2) Loss

Section 1271(a) applies equally to gains and losses. Thus, a loss resulting from contingent payments being less than the fair market value of the contingent payment right at Closing would be capital loss. The fact that the loss results from the terms of the contingent payment instrument itself, and not from a credit risk, changing interest rates or other market factors suggests that section 166 is not available to convert this capital loss to an ordinary bad debt deduction. Also, under Reg. § 1.166-1(c), a bad debt deduction is available only for a "bona fide debt," defined as an "obligation to pay a fixed and determinable amount." This rule seems to prevent contingent payment rights from being eligible for an ordinary deduction under section 166, even if the loss results from a default by Acquiror (much less if it results from the terms of the right itself). *See Mann Const. Co. v. Commissioner*, T.C. Memo. 1999-183, and cases cited therein.

(3) Is the Right to Contingent Purchase Price Payments a "Debt Instrument" (or Equity)?

(a) "Debt Instrument" Defined

The broad definition of "debt instrument" in section 1275(a)(1) ("bond, debenture, note, or certificate or other evidence of indebtedness") and Reg. § 1.1275-1(d) ("instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law") could include a right to contingent purchase price payments. The regulations state that contingent payment rights may be debt instruments. Reg. §§ 1.001-1(g)(2) and 1.1275-4.

(b) Debt vs. Equity

A right to contingent purchase price payments normally should qualify as "indebtedness [of Acquiror] under general principles of Federal income tax law" under Reg. § 1.1275-1(d), as opposed to equity, as long as Acquiror is financially able to pay the obligation. Compare TAM 9840001 (Oct. 2, 1998) (contingent payment right not debt where obligation to make payments entirely dependent on ability to collect payments from third parties with poor credit ratings, and payments due only on amount remaining after collection costs and servicing fees) with *Commissioner v. Hansen*, 360 U.S. 46 (1959) (debt found with virtual guarantee of payment but otherwise similar facts). Even if the right is equity, the "redemption" of this equity by Acquiror normally would result in capital gain or loss to Seller (subject to section 302 or section 165(g)(3)). In such a case, however, no interest would be imputed. *See also* part III.D., below, on escrows of stock of Acquiror in taxable acquisitions.

g. Closed Transaction Method – Treatment of Principal Amounts – Character of Gain or Loss – Contingent Purchase Price Payment Right as Contractual Right Other Than Debt Instrument (or Equity)

A right to contingent purchase price payments could be characterized, not as a debt instrument or an equity interest issued by Acquiror, but instead as a contractual right against Acquiror. If so, determining whether the gain or loss is ordinary or capital entails a complex case law inquiry which takes section 1234A into account, along with other rules. The 1997 revision of section 1234A seems to dictate "sale or exchange" treatment when the contingent payment right is satisfied (thus suggesting capital gain or loss), but the scope of this provision is uncertain.

For a review of the case law on the character of income from payments to extinguish or transfer contract rights, *see* N. Schmelzer, "Taxation of Transfers of Contract Rights," 98 Tax Notes 228 (Jan. 13, 2003). For discussion arguing that gain on a contingent payment right is ordinary income, *see* J. Kwall, "Out With The Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales," 81 N.C.L.Rev. 977 (2003).

(1) Issues

Under section 1221, capital gain or loss is recognized on a sale or exchange of property that is a capital asset in the seller's hands. In confronting the question whether a payment received for the transfer or termination of a contract right is taxed as capital gain or loss or as ordinary income or loss, courts have examined two issues: (a) Was the disposition a sale or exchange? and (b) was the transferred or terminated right a capital asset?

(2) The Courts' Approach

When a person has a contractual right to receive a guaranteed stream of ordinary income and surrenders this right for a lump sum, courts generally hold that the lump sum (less any basis in the contractual right) is ordinary income. Some courts justify the conclusion on the ground that the right is not a capital asset; others hold that there is no sale or exchange. Sometimes it is difficult to determine which is the reason for the decision. Thus, the best way to approach this issue is to inquire into (a) the identity of the parties to the transaction (which, under the "extinguishment doctrine," influences and may determine the outcome of the "sale or exchange" issue) and (b) the character of the rights involved.

(3) Sale or Exchange – Who are the Parties?

(a) Historical Approach – the Extinguishment Doctrine

During the 1940s and 1950s, courts struggled with the question whether a payment made by one party to a contract to extinguish another party's right under the contract was a "sale or exchange" of the right that could result in capital gain or loss.

This "extinguishment doctrine" held that the transaction was not a sale or exchange, because when cancelled the right disappears or is extinguished, rather than being "sold" by the holder to the obligee. *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952) (corporate liquidation in which shareholder received loans, mortgages, etc., was closed transaction; later gain from collections was ordinary income); *Commissioner v. Starr Bros.*, 204 F.2d 673 (2d Cir. 1953) (payment received by retail distributor from manufacturer for waiver of contract provision prohibiting manufacturer from selling to taxpayer's competitors held ordinary income); *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953) (payments received by booking agent for canceling exclusive arrangement with Frank Sinatra held ordinary income); *Commissioner v. Pittston Co.*, 252 F.2d 344 (2d Cir. 1958) (taxpayer loaned $250,000 to developer of coal properties; developer agreed to sell taxpayer all coal produced at properties for 10 years at a discount; two years later, after loan was repaid, developer paid taxpayer $500,000 to cancel discount right; following *Starr* and *General Artists*, cancellation of right held not sale or exchange).

Some transactions that looked like extinguishments, however, were accorded capital gain or loss treatment, *e.g.*, surrenders of leases by lessees to their lessors for cash. *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954); *Commissioner. v. Golonsky*, 200 F.2d 72 (3d Cir. 1952); *Hort v. Commissioner*, 313 U.S. 28 (1941). The courts' theory was that relinquishing a leasehold is analogous to a life tenant's transfer of his or her interest to a remainderman, which had been held to generate capital gain in *Bell's Estate v. Commissioner*, 137 F.2d 14 (8th Cir. 1943), and *Allen v. First National Bank and Trust Co.*, 157 F.2d 592 (5th Cir. 1946) (treating life estate as capital asset - result codified in section 1241. On the other hand, a payment by a lessee to a lessor to cancel the lessee's obligation was held to be ordinary income (Reg. § 1.61-8(b)), as was even a sale of a lessor's rights under a lease (*Oliver v. Commissioner*, 364 F.2d 57 (8th Cir. 1966)).

(b) *Commissioner v. Ferrer*

The extinguishment doctrine was dealt a heavy blow in *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962). There, Jose Ferrer, a show business figure, secured rights to a novel and a play based on the novel. These rights included (1) exclusive right to produce the play, (2) power to restrain the author from conveying film rights to the play for a specified period, and (3) if Ferrer produced the play as promised, right to a percentage of proceeds from any subsequent sale of motion picture rights. Ferrer surrendered these rights for a percentage of the profits of a film based on the novel, which Ferrer produced and in which he starred. The court examined each of the surrendered rights individually to determine whether the amount received for each of the rights was capital gain or ordinary income. The court held that the amount traceable to the right to produce the play was capital gain, because this right was akin to a leasehold interest, as in *McCue* and *Golonsky*, and because the amount received was not equivalent to the amount Ferrer would have received if he had retained the production rights he surrendered. The amount received for the right to restrain the author's conveyance of film rights was also given capital gain treatment, because the contract had given Ferrer equitable remedies with regard to the property. The amount traceable to the motion picture proceeds, however, was considered ordinary income, because the right could not be considered an estate in any property.

(c) Importance of *Ferrer*

The *Ferrer* court focused on the character of the rights transferred (as discussed in part I.C.2.g.(4), below), rather than the recipient of the rights. The court dubbed "formalistic" the *Starr* and *General Artists* distinction between a sale to a third person and a release and also found the extinguishment doctrine to be at odds with the substance-over-form doctrine.

(d) Courts and IRS Distinguish *Ferrer*

Even after *Ferrer*, the courts and IRS continued to apply the extinguishment doctrine in some instances. As examples, in *Billy Rose's Diamond Horseshoe, Inc. v. Commissioner,* 448 F.2d 549 (2d Cir. 1971), a lessee paid its lessor for a release from an obligation to restore the leased premises. The court denied the lessor use of installment sale method under section 453, because there was no sale of property, citing *Pittston* for the proposition that a release of a contract right is not a sale. The court distinguished *Ferrer* on the ground that the rights to the play there were transferable (even though not actually transferred) to a third party. The result in *Billy Rose* could also be explained by the character of the released right not being an interest in underlying property and so not a capital asset.

In *Dorsey v. Commissioner,* 49 T.C. 606 (1968), an open-vs.-closed transaction case, the court put the issue clearly and simply at the beginning of its opinion:

> The principal issue in these cases is whether certain amounts received by the petitioners during the years in controversy are taxable as capital gains or as ordinary income. The answer depends upon whether assets distributed in kind to petitioners, as stockholders of the Automatic Pinsetter Co., had an ascertainable fair market value when the corporation liquidated on September 16, 1954.

IRS also seems to have adopted the extinguishment doctrine in Rev. Rul. 75-527, 1975-2 CB 30 (no sale, and so no capital gain, upon release of right to heat a building, because right was extinguished rather than being "passed" to another party).

(e) Section 1234A Codifies *Ferrer*

Section 1234A treats a cancellation, lapse, expiration or other termination of a right or obligation with respect to certain property which is (or would be upon acquisition) a capital asset in the hands of the taxpayer as a "sale or exchange." H.R. Conf. Rep. No. 105-220, 454 (1997). As originally enacted in 1981, section 1234A applied only to actively traded personal property and futures contracts. P.L. 97-34, § 507; P.L. 97-448, § 105. In 1984 and again in 1997, section 1234A was expanded, and it now applies to all types of property—so long as the underlying property is a capital asset. This extension was necessary due to Congress's perception that similar transactions were receiving inconsistent treatment. S. Rep. No. 33, 132, 133 (1997). The legislative history further states that the amendment to section 1234A –

> ...extends to all types of property the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

H.R. Conf. Rep. No. 105-220 at 454 (1997). Congress was concerned about the case law's lack of uniformity in the treatment of transactions that terminate contractual rights and the resulting treatment of similar transactions in different ways. Thus Congress intended that, when section 1234A applies, the gain or loss resulting from the liquidation of a contingent payment right will be capital gain or loss. *See also* discussion of section 1271(a) in part I.C.2.f.(1), above. Both on its face and viewed in light of its legislative history, then, section 1234A seems to foreclose the extinguishment doctrine. So long as the contract right is a capital asset, its "cancellation, lapse, expiration, or other termination" is treated as a sale, and capital gain or loss results.

Is a payment received under the terms of a contract a payment in "cancellation, lapse, expiration or other termination" of contract under section 1234A? This basic question has never been answered. It would appear at least, though, that the case for capital gain or loss under section 1234A is weakened where the contract calls for a stream of payments, not a single payment (unless right to each payment is treated as a separate contractual obligation), and where the payments are made in accordance with the terms of the contract.

(f) IRS Still Relies on Extinguishment Doctrine – Treatment to Recipient of Payment to Release Contract

In TAM 200049009 (Aug. 9, 2000) and TAM 200427025 (Dec. 9, 2003), IRS continued to apply the extinguishment doctrine. At issue in both TAMs was whether the owner of a "qualified facility" under the Public Utility Regulatory Policy Act of 1978 ("PURPA") could treat as capital gain an amount received from a public utility for releasing the owner's right to sell its power output to the utility. *See* further discussion in part I.C.2.g.(3)(g), below. IRS concluded that the contract right was "property" within the meaning of section 1221 but treated the receipt as ordinary income on the ground that the release of the contract right was an extinguishment, not a sale or exchange. In both TAMs IRS stated:

> [T]he extinguishment doctrine has faced considerable criticism over its half-century history, yet it remains a feature of the tax law; Congress has reduced the scope of the doctrine but has not, as yet, eliminated it altogether.

In support of this conclusion, IRS relied principally on *Wolff v. Commissioner,* 148 F.3d 186 (2d Cir. 1998), and *Nahey v. Commissioner*, 111 T.C. 256 (1998), *aff'd*, 196 F.3d 866 (7th Cir. 1999).

In *Wolff*, the court held that a fee paid to cancel one leg of a commodity forward contract was an ordinary loss to the payor, due to lack of a sale or exchange. However, as IRS noted, the transaction in *Wolff* occurred before enactment of even the original section 1234A. Further, a burdensome contract is more like a liability than "property," and so a payment to cancel such a contract may generate an ordinary deduction to the payor, regardless of its treatment to the recipient. *See* part I.C.2.g.(3)(g), below.

Nahey supports the extinguishment doctrine, but, as in *Wolff*, the transaction in *Nahey* was not subject to section 1234A. If the *Nahey* transaction occurred today, it would seem to fall within section 1234A, which would require reconciling the extinguishment doctrine with that section, a task that seems impossible. Because neither of the *Nahey* courts had any reason to attempt this reconciliation, *Nahey*'s support for the extinguishment doctrine is dubious, and IRS's reliance on it for that purpose seems misplaced. In *Nahey*, the taxpayer bought the assets of a business, including a claim in a pending lawsuit involving lost income. None of the purchase price was allocated to the claim. Later the taxpayer settled the lawsuit at a gain. The Tax Court concluded that the proceeds were ordinary income, because the settlement extinguished the claim and so no sale or exchange occurred. The Tax Court distinguished *Ferrer* on the basis that, whereas the claim in the lawsuit "vanished in both form and substance upon the receipt of the settlement proceeds," Ferrer's "interest (or lease) to produce the play and prevent the author's transfer of film rights did not disappear but instead reverted to the author after [Ferrer] surrendered the lease…" This distinction is not easy to discern. The Seventh Circuit took an entirely different approach to the same result:

> [W]e cannot find any practical reason for why the tax treatment of the proceeds of a suit should change merely because of an intervening change in ownership. Recall the taxpayers' concession that if [seller] had obtained the settlement the proceeds would have been taxable to [seller] as ordinary income, not as capital gain.

This analysis too is questionable. As the concurring judge pointed out (and as discussed further in part IV., below), if, instead of buying a claim under a lawsuit and receiving a payment in settlement, Nahey had assumed an obligation under a lawsuit and paid a settlement, the payment would have been (1) added to Nahey's basis in the purchased assets and (2) added to the seller's amount realized on the sale, with the seller being allowed an offsetting deduction. In other words, the "intervening change in ownership" would not have affected the seller's treatment of its obligation, but the buyer's treatment would have determined by nature of the transaction that caused the "change in ownership." The inconsistency between the treatment on the payment side and the Seventh Circuit's treatment of the receipt side constitutes a real problem with the analysis in *Nahey*.

(g) IRS Still Uses Extinguishment Doctrine – Treatment of the Payor of Payment to Release Contract

In several private rulings, IRS dealt with the other side of the PURPA settlements described above. In each of these rulings, IRS allowed ordinary deductions to public utilities that buy out PURPA contract rights held by owners of qualified facilities. PLR 20051035 (Sept. 26, 2005); PLR 200051033 (Sept. 25, 2000); PLR 19913032 (April 5, 1999); PLR 9842006 (Oct. 16, 1998). In each of these rulings, after the contract was entered into, the market price of energy dropped sharply, and the utility paid the owner of the qualified facility to release the owner's right to sell output to the utility at the contract price. IRS allowed the utilities to deduct the amounts paid under section 162. Neither section 1234A nor the extinguishment doctrine was mentioned. Instead, IRS reasoned that courts have allowed taxpayers to deduct amounts paid to terminate burdensome and uneconomic contracts (*Capitol Indemnity Ins. Co. v. Commissioner*, 237 F.2d 901, 903 (7th Cir. 1956)) and amounts paid solely to reduce or eliminate future costs (*T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. 581, 589 (1993)). This general rule, with specific exceptions, appears in the regulations dealing with the requirement to capitalize amounts paid to acquire or create intangibles. Reg. §§ 1.263(a)-4(b)(3)(ii); 1.263(a)-4(d)(7); 1.263(a)-5(c)(8). IRS's failure to apply either section 1234A or the extinguishment doctrine (in the IRS view still legitimate) could be thought inconsistent with the statement in TAM 200049009 that PURPA contract rights are property for section 1221 purposes. The explanation could be that, because the contracts in the PLRs had become burdensome to the utilities, they were not "property" to them but were instead obligations. Thus, the payments to release the contracts could be considered akin to a premium, paid by a borrower, for which the borrower gets an ordinary deduction. Reg. § 1.163-4(c). If this is the rationale, it is not inconsistent with section 1234A, because that provision determines "sale or exchange" treatment, not capital asset treatment.

(h) Conclusion

Despite TAM 200049009 and TAM 200427025 (discussed in part I.C.2.g.(3)(f), above), in the author's view the extinguishment doctrine should not determine the character of gain or loss on payments of contingent purchase price to Seller under the closed transaction method. In other words, if a contractual right either changes hands or is surrendered, the transaction is probably a "sale or exchange" for section 1221 purposes. If this view prevails, the only remaining issues are whether the contractual right to receive contingent sale price constitutes a capital asset (discussed in part I.C.2.g.(4), immediately below), and whether payments made in accordance with the terms of the that contract (discussed in part I.C.2.g.(5), below).

(4) What is the Character of the Contract Rights?

There is no single determinative factor in determining whether a contract right is a capital asset. There are dozens of decisions on point, and each of them seemingly uses a different set of factors. The cases generally deal with sales or dispositions of contract rights, as opposed to payments in satisfaction of them—as would be the case here. Still, the cases are relevant. The most important factors are set forth below:

(a) Whether the Rights Are Incidental to or Create an Estate in Property

This factor asks whether a contract right represents an equitable interest in underlying property or just a right to income. In *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962), rights to produce a play and to restrain the play's author from conveying rights to others were considered capital assets, because they represented interests in the play itself. *See* part I.C.2.g.(3)(b), above. Conversely, a right to receive a percentage of profits from selling film rights to a book was held not to be an interest in the book itself. *See also Metropolitan Building Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960) (lessee's leasehold interest is a capital asset).

(b) Whether the Rights Can Appreciate or Depreciate in Value

One of Congress's purposes in granting favorable tax treatment to capital gains is to reduce the burden of recognizing in a single year gain from assets that have appreciated over time. *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134 (1960). In *Estate of Shea v. Commissioner*, 57 T.C. 15 (1971), the question was whether gain from disposition of a shipping charter gave rise to ordinary income or capital gain. The court allowed capital gain treatment after noting that the price of charters fluctuates depending on supply of and demand for boats, "due purely to the action of market forces." *See also Burnet v. Harmel,* 287 U.S. 103, 106 (1932) (capital gain treatment only for "situations typically involving the realization of appreciation in value accrued over a substantial period of time"); PLR 200215037 (Jan. 14, 2002) (qualified facility's PURPA contract is capital asset to owner of facility in part because profit or loss derived therefrom depends on fluctuating market price of electricity—compare treatment of utility, described in part I.C.2.g.(3)(g), above). If a market exists for the contract right, the value of the right will fluctuate. FSA 200130002 (July 27, 2001) (citing Ferrer, sale of rights to license and distribute a popular television talk show was sale of capital asset).

(c) Whether the Rights Entail Goodwill

The fact that part of the value of a contract right is traceable to goodwill suggests that a transfer of the contract involves an underlying asset, not just a right to receive future income. As a result, capital gain or loss is more likely. *Bankers Guarantee Title & Trust Co. v. United States*, 418 F.2d 1084 (6th Cir. 1969); *Bisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (5th Cir. 1963); *Nelson*

Weaver Realty Co. v. Commissioner, 307 F.2d 897 (1962) (sale of right to service life insurance contracts included a property right which was the equivalent of goodwill, and capital gain treatment resulted).

(d) Whether the Taxpayer Made a Capital Investment and Has Basis

If the value of a contract right arises from personal effort, ordinary income treatment is likely. Conversely, a financial investment that gives rise to basis is characteristic of a capital asset. For example, in *Foy v. Commissioner*, 84 T.C. 50 (1985), the taxpayer created a network of janitorial franchises and, for a share of revenues, guaranteed franchisees certain numbers of contracts and levels of sales. The taxpayer then transferred his interest and obligations to a third party. The court held that the taxpayer was so involved in the development and operation of the franchise network that the rights he sold constituted a proprietary interest similar to that of an equity owner, and the sold property was held to be a capital asset. Key to the court's analysis was its view that the sorts of business risks assumed by Foy "are not typically assumed by mere employees or salesmen who have no ownership interest in the business." *See* also *Bellamy v. Commissioner*, 43 T.C. 487 (1965) (lack of taxpayer investment held determinative of ordinary income).

(e) Whether the Rights Originated with the Holder

The fact that a contract right originated with the holder suggests that its value is due to personal service and yields ordinary income. If the right originated with a third party, however, the holder more likely holds it as an investment. *Compare Miller v. Commissioner*, 299 F.2d 706 (2d Cir. 1962) (wife of band leader Glenn Miller denied capital gain on sale of production rights to movie about her husband), with *Ferrer* (capital gain on sale of rights to play written by another playwright). *But see Nahey* (collection in settlement of purchased lawsuit claim ordinary income, because collection by seller would have ordinary income).

(f) Whether the Taxpayer Parted with All its Rights

The fact that the taxpayer retains an interest in transferred property suggests that the transfer does not alter the underlying investment, an indication that an ordinary income stream remains. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). This factor also suggests the absence of a sale or exchange.

(g) Whether Transfer of Contract Rights Merely Substitutes Source of Ordinary Income

If the proceeds of a transfer substitute for what would have been ordinary income to the seller, most courts conclude that capital gain is unavailable. Examples include a payment by a lessee to its lessor to terminate a lease (Reg. § 1.61-8(b)); a sale of a right to collect previously-accrued income (*Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962); *Fisher v. Commissioner*, 209 F.2d 513 (6th Cir. 1954)); a right to film royalties (*Lasky v. Commissioner*, 22 T.C. 13 (1954)); a share in profits from a mining venture (*Ayrton Metal Co., Inc. v. Commissioner*, 299 F.2d 741 (2d Cir. 1962)); and a right to declared but unpaid dividends (*Rhodes Est. v. Commissioner*, 131 F.2d 50 (6th Cir. 1942)). Transactions involving personal services generally result in ordinary income. *Flower v. Commissioner*, 61 T.C. 140 (1973) (right to promote pharmaceutical products); *Maryland Coal & Coke Co. v. McGinness*, 350 F.2d 293 (3d Cir. 1965) (right to sell output of a mine); *Lozoff v. U.S.*, 266 F. Supp. 966 (E.D. Wis. 1967) (right to act as a purchasing agent);

Foote v. Commissioner, 81 T.C. 930 (1983) (amounts paid to taxpayer by college in consideration of his relinquishment of tenure as professor were ordinary income).

(5) Treatment of Principal Amounts – Conclusion: Is Gain or Loss on a Right to Contingent Purchase Price Payments Capital or Ordinary?

If a right to contingent purchase price payments is a debt instrument, gain or loss will be capital gain or loss under section 1271(a). Especially considering the breadth of the definition of "debt instrument," a contingent purchase price payment right could well qualify. The fact that the right involves strictly cash payments (like a note) and the fact that the right arises as a result of a sale of a business both seem to suggest this result. *See* part I.C.2.f., above.

Even if a right to contingent purchase price payments is a contract right (not a debt instrument), based on the factors discussed in part I.C.2.g.(4), above, good arguments can be made for capital gain or loss. Basis will exist in the right to receive the contingent payments, and the value of this right is likely to appreciate or depreciate in value based on, *e.g.*, interest rates and business factors. On the other hand, the fact that payments are made under the terms of the contract itself (and not in settlement or buy-out of the right) suggests that the payments are not parts of a sale or exchange. *Nahey v. Commissioner*, (discussed in part I.C.2.g.(3)(f), above); *Campagna v. United States*, 290 F.2d 682 (2d Cir. 1961) (shareholder received mortgage valued at 20% of face amount in corporate liquidation and then received excess proceeds; excess held ordinary income).

Section 1234A may or may not change the outcome. Even though it mandates "sale or exchange" treatment for "cancellation, lapse, expiration or other termination" of a contractual right, payment under the terms of the contract itself may be a fulfillment of the right, not a cancellation, etc. Query whether the language in section 1234A is meant to have a narrower meaning than "retirement," as used in section 1271(a), relating to debt instruments. In *Samueli v. Commissioner,* 108 AFTR 2d 2011-6270 (9th Cir. 2011) the court held that the receipt of a payment in fulfillment of the payor's contractual obligation to deliver securities was not "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of...a right or obligation...with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" under section 1234A.

Even if section 1234A does apply, there remains the question whether the right to contingent purchase price payments itself is a capital asset. For discussion of an analogous issue, *see* M.A. Stevens, "The Tax Treatment of Contingent Options," 102 Tax Notes 535 (Jan. 26, 2004) (pointing out that a premium received in payment for a contingent option may be taxable when received, even though a premium received for a non-contingent option is taxed only when the option either is exercised or expires). *See also* ABA Section of Tax'n, "Options for Tax Reform in the Financial Transactions Provisions of the Internal Revenue Code (Dec. 2, 2011) (advocating amendment to section 1234A "to provide that the character of any gain or loss attributable to the disposition or termination of a right or obligation other than with respect to property...shall be the same as the character of any gain that would have resulted from a sale of the right or obligation").

The complexity of this issue and the uncertainty of the outcome are frustrating to taxpayers and their advisers. The same situation creates planning opportunities, however, such as allowing taxpayers to report capital gain where there is gain and ordinary loss where there is loss. This uncertainty compounds the uncertainty as to whether open transaction treatment is available in gain situations and creates yet more incentive to taxpayers to use the open transaction method. On the other hand, these two types of uncertainty combined leave sellers with exposure to ordinary income treatment of contingent purchase price received (if open transaction treatment turns out not to be available, and the receipt is ordinary income, not capital gain. The only way to avoid this exposure is to use the installment method.

3. Open Transaction Method

In the "rare and extraordinary" case where Seller's contingent payment right is not susceptible to valuation, the transaction remains open, and, when the amounts become includible under Seller's method of accounting, Seller has additional amount realized on the sale and imputed interest income. Reg. § 1.1001-1(a).

a. Open Transaction Method – Advantage Over Other Methods

In a sale at a gain, the open transaction method is usually advantageous, as compared with both the generally-applicable closed transaction and installment methods. Under the open transaction method, the basis of the assets sold is recovered up-front, with gain recognized only after full basis recovery.

If the asset sold is a capital asset, capital gain treatment is clear. The only exception is that, under Reg. § 1.483-4, a portion of each actual payment is treated as ordinary interest income received by Seller and currently-deductible interest paid by Acquiror. There is no original issue discount or other taxable or deductible accrual of interest. This treatment contrasts with the treatment of "contingent payment debt instruments," in financial transactions. Under Reg. § 1.1275-4, these instruments accrue interest at a "comparable yield" for noncontingent debt.

b. Open Transaction Method – Loss

Seller may not claim a loss at Closing if contingent payments still may be received (unless, and to the extent that, the sum of the fixed payments and the maximum amounts of the contingent payments are less than asset basis). PLR 8217183 (Jan. 29, 1982), supplemented by PLR 8221081 (Feb. 25, 1982); *cf. Schmidt v. Commissioner*, 55 T.C. 335 (1970) (no loss to shareholder on corporate liquidation until complete). If gain assets and loss assets are sold in the same transaction, and if contingent purchase price is allocated in part to the loss assets under the open transaction method, the loss is deferred, but the gain is recognized as payments of purchase price are received, once the basis of the gain assets has been recovered. The result could be an acceleration of tax, as compared with the closed transaction method.

It may be possible to prevent this acceleration of tax by allocating cash or other fixed consideration to high-basis assets and the open-transaction contingent consideration to lower-basis assets. Section 1060 does not prohibit special allocation of types of consideration to different assets, even if they are sold as part of an "applicable asset acquisition" subject to the residual method, but PLR 200004040 (Oct. 24, 1999) and LAFA 20080101F (Dec. 3, 2007), suggest that such an allocation may not be proper where the effect is to thwart the proportionate recovery of asset basis in an installment sale. These authorities are discussed in parts I.B.4. and I.B.5.b.(2), above, in the context of an installment sale.

c. Open Transaction Method – Applicability

(1) General Limited Applicability

The open transaction method applies only if the contingent purchase price obligation received by Seller cannot be valued. Courts have been reluctant to accept an assertion that property received by a taxpayer cannot be valued, but taxpayers are sometimes successful.

Authorities involving claimed open transactions include *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947) (proceeds of sale of land easement all offset against full basis in land under open transaction method); *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952) (corporate liquidation in which shareholder received loans, mortgages, etc., was closed transaction; later gain from collections was ordinary income); *Liftin v. Commissioner*, 36 T.C. 909 (1961) (purchaser of notes at a discount could recover full basis before recognizing gain—open transaction); *Wingate v. Commissioner*, 45 T.C. 489 (1966) (same); *Dorsey v. Commissioner*, 49 T.C. 606 (1966) (corporate liquidation in which shareholders received contractual right to share of receipts from new automatic pinsetting equipment was open transaction, and amounts received were capital gain from liquidation; new and untried business model for bowling industry decisive); *MacDonald v. Commissioner*, 55 T.C. 840 (1971) (license of new hardboard manufacturing process for royalty payments taxed as sale and open transaction; royalty payments treated as basis recovery and then capital gain; earlier licenses were different enough from license at issue so that value could not be based on history); *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973) (cash method taxpayer sold apartment building for cash and contract obligation to make payments with bullet after 15 years; contract could be transferred only at substantial discount; based on history of § 1001 and enactment of § 453, "cash equivalent" test for gain realization applied by Tax Court rejected; transaction closed, and amount realized on sale measured by reference to FMV of contract); *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979) (real estate developer sold lots for future payments under contract with no mortgage or other security and other contingencies; open transaction treatment allowed; taxpayer could recover basis before recognizing any taxable gain or income); and Rev. Rul. 58-402, 1958-2 CB 15 (contracts and claims to receive indefinite amounts, such as those received in corporate liquidation, must be valued for tax purposes except in rare and extraordinary cases).

Cases involving stock options illustrate the courts' reluctance to accept open transaction treatment. When such an option is a component of a price paid for goods or services (generally a discount or rebate) or interest in a financing transaction, the value of the option is generally taken into account at the time the option is granted, and not, as in a compensation arrangement, when the option is exercised. *Custom Chrome, Inc. v. Commissioner*, 217 F.3d 1117 (9th Cir. 2000), (warrants issued to lender valued at time loan was made and included in original issue discount). *See also Computervision Int'l Inc. v. Commissioner*, 1996 T.C. Memo 131 (1996); *Sun Microsystems Inc. v. Commissioner*, 1993 T.C. Memo 467 (1993) (warrants represented sale discount whose value was excludable from gross income but taken into account in basis of purchased equipment); *Centel Communications v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990) (warrants issued in recognition of loan guarantees not subject to § 83; issuer not entitled to deduction, no ordinary income to holders on exercise); *Monarch Cement Co. v. United States*, 634 F.2d 484 (10th Cir. 1980) (stock warrants issued in connection with a note treated as discount amortizable over the term of loan; warrants valued at time of loan); TAM 200043013 (Oct. 30, 2000) (warrants issued to bank in connection with bankruptcy reorganization not transferred in connection with services performed by bank; if warrants have value at time of issuance, there is original issue discount on loan by bank deductible over the life of loan); TAM 9737001 (May 23, 1997) (§ 83 did not apply to warrants issued to cable companies in connection with affiliation agreements providing channel access; warrants were not granted in connection with services but as an inducement to obtain more channel access).

If the option cannot be valued, *i.e.*, if the transaction involves one of the "rare and extraordinary cases" mentioned in Reg. § 1.1001-1(a), presumably the option is taken into account later when the open transaction closes upon exercise, lapse, transfer or cash settlement.

This treatment preempts the general rules in § 1234 to the effect that an option on stock, securities, commodities and commodities futures is an open transaction to both grantor and holder; that, for the option holder, a sale of the option is treated as a sale of the underlying property, and a lapse is treated as a sale or exchange; and that, for the grantor, any gain or loss from a lapse of the option of a "closing transaction" that terminates the holder's obligation results in short-term capital loss.

For other authorities relating to options, *see* T.D. 9612, 78 Fed. Reg. 7,997 (Feb. 5, 2013) (noncompensatory options on partnership interests); *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (offsetting put and call options on stock not treated as current sale of stock because of differences in terms); Rev. Rul. 85-87, 1985-1 CB 268 (sale of stock at a loss coupled with sale of "in-the-money" put on the same stock; put treated as contract to acquire the stock and caused loss to be disallowed under wash sale rules). *See also* part V.B.3., below, for discussion of nonqualified compensatory stock options assumed by Acquiror after a purchase of Target stock, and part IX., below, for discussion of stock options received in tax-free acquisitions.

(2) Possible Similar Treatment to Sellers on Accrual Method of Accounting

Income is includable in the gross income of an accrual method taxpayer "when all the events have occurred that fix the right to receive such income and the amount of the income can be determined with reasonable accuracy." Reg. § 1.446-1(c)(1)(ii). *See also* Reg. § 1.451-1(a). This rule has been applied to sales of goods in the ordinary course of business where pricing is contingent on negotiations. *Globe Corp. v. Commissioner*, 20 T.C. 299 (1953). Thus, the question is raised whether contingent consideration received in a sale of a business (or any capital asset such as stock of a subsidiary) can be deferred based on this rule, as opposed to being taxed as a closed transaction (unless the transaction involves a "rare and extraordinary case" in which the open transaction method applies). Another way to state the question is this: Does Acquiror's obligation to pay contingent purchase price to Seller constitute (i) a right to receive gross income subject to accrual method rules or (ii) "property" subject to Reg. § 1.1001-1(a). This issue arose in *Nestlé Holdings, Inc. v. Commissioner*, 94 T.C. 803 (1990). There, an accrual method Seller transferred inventory of a discontinued business to Acquiror in exchange for Acquiror's notes and preferred stock. The Court held that the preferred stock was "property" under section 1001(b), not an unconditional right to receive money in the future; so that Seller's amount realized was based on the fair market value of the stock, not its redemption price.

In the case of a sale of property that could be subject to the installment method, section 1001(b) and Reg. § 1.1001-1(g)((1)(ii) seem to control. Reg. § 15a.453-1(d)(2)(iii) provides that, if an accrual method Seller receives a "contingent payment obligation and elects out of the installment method, Seller "must report an amount realized in the year of sale determined in accordance with that method of accounting, but in no event less than the fair market value of the contingent payment obligation." Echoing Reg. § 1.1001-1(a), the regulation also provides that Seller may treat the transaction as "open" only in "those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation...cannot be reasonably ascertained."

Reg. § 15a.453-1(d)(2)(iii) applies to sales of property in which Seller elects out of the installment method. If a sale of a business includes property that could not be sold under the installment method (*e.g.*, inventory), that regulation seems not to apply to the extent contingent sale price is allocated to that property. Thus, it is not clear whether that sale is subject to accrual method accounting (open transaction treatment for contingent sale price even if the right to contingent sale price can be valued) or to Reg. § 1.1001-1(a) (amount realized at closing includes fair market value of contingent sale price; open transaction treatment only in "rare and extraordinary cases"). *See* parts I.B.4. and I.B.5.b.(2), above, for discussion of in-kind allocations of sale price among items of property.

d. Open Transaction Method – Royalty Transactions

In connection with a sale of its business, Seller may retain ownership of intangible property (*e.g.*, patents and trademarks) and license use of the property by Acquiror for contingent payments based on use or productivity. Seller would recognize income from the royalties when the amounts are received or fixed. This treatment applies only if Seller retains sufficient ownership rights in the intangible property such that the arrangement qualifies as a license, not an installment sale. Section 1253; Rev. Rul. 55-540, 1955-2 CB 39 (sale vs. lease).

e. Open Transaction Method Under Attack? – Prepaid Forward Contracts

An important advantage of the open transaction method to Seller is that no interest or other income accrues to Seller until cash is received. In Notice 2008-2, 2008-1 CB 252, Treasury and IRS requested comments on the tax treatment of prepaid forward contracts and exchange traded notes, which are taxed under an open transaction method. The Notice asks, inter alia, whether income should accrue under these contracts. One of the subjects on which comments is requested is:

> How an accrual regime might be designed so that it does not inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce.

Nevertheless, if prepaid forward contracts are subjected to such a regime, could sales of businesses for contingent consideration now receiving open transaction treatment become subject to a similar regime?

f. Recent Cases on Open Transaction Method

(1) Demutualization Cases

Several courts have dealt with the tax consequences of conversions of mutual life insurance companies into stock companies. In these cases, the life insurance policyholders surrendered their policies and received identical policies issued by the new stock company and, in exchange for their equity interests in the mutual companies, they received stock of the new company or cash in lieu of stock. The issue concerns the basis of the stock received (or the basis that affects gain from receipt of the cash).

IRS took the position that the exchange of equity for stock or cash was taxable, and that the full value of the stock (or the full amount of the cash) was taxable currently, because none of the cost basis in the taxpayers' interest in the mutual company (life insurance policy and equity) was allocable to the equity. The IRS conclusion was based mainly on the equity interest not being transferable separately from the policy and having speculative value.

Apart from cases dealing with procedural matters (*see Cadrecha v. United States*, 109 AFTR 2d 2012-1664 (Ct. 2012), and *Illinois Lumber and Material Dealers Association Health Insurance Trust v. United States*, 113 AFTR 2d 2014-1937 (D. Minn. 2014), three cases have dealt with the substantive issues and reached three different conclusions:

(a) *Fisher v. United States*

In *Fisher v. United States*, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Ct. Fed. Cl. 2008), *aff'd without opinion*, 209 WL 3241381 (Fed. Cir. 2009), the court rejected the IRS argument and in fact turned the argument on its head. The court held that the policy holder could recover all of his cost basis before recognizing any taxable gain. The court relied on open transaction principles that allow full basis recovery against uncertain receipts and cases involving sales of easements and other partial interests in land. The opinion also casts doubt on the rationale for the statement in Reg. § 1.1001-1(a) that open transaction treatment applies "only in rare and extraordinary cases."

(b) *Dorrance v. United States*

In *Dorrance v. United States*, 111 AFTR 2d 2013-1280 (D. Az. 2013), as in *Fisher*, the IRS position was that the policy holder's basis in the stock was zero, and the policy holder's position was that, under the open transaction method, he was entitled to apply the full amount of premiums paid to the basis of the stock he received. In denying cross-motions for summary judgment, the court held that both the insurance policies and the stock received could be valued, and that the open transaction doctrine did not apply, but also that the parties had not provided evidence to perform the allocation of basis. 877 F. Supp. 827 (D. Az. 2012). Ultimately, the court held that the taxpayer's basis could not be determined at the time of the demutualization simply by the premiums paid for his policies but could be determined based on factors such as the value of the company's stock sold in a public offering, In other words, the court did not use the open transaction analysis used by the court in *Fisher*.

(c) *Reuben v. United States*

In *Reuben v. United States*, 111 AFTR 2d 2013-620 (C.D. Cal. 2013), the court granted the government's motion for summary judgment and denied the taxpayer's cross-motion. The court declined to follow *Fisher* and held that the open transaction method is limited to transactions that will "close" later, like a sale for contingent purchase price that cannot be valued at Closing. The court contrasted the situation before it with such situations, because basis is irrelevant when a life insurance policy pays off upon the death of the insured, with a resulting windfall to the taxpayer. Based on testimony from an independent actuary, the court also concluded that the taxpayer's equity rights were a "windfall" and had no basis.

(d) Significance of the Demutualization Cases to Contingent Purchase Price Sales

Of the three decisions on the merits of the demutualization issue, only the *Fisher* decision followed the open transaction method. Irrespective of the ultimate disposition of the issue (if one occurs), the cases focus attention on an important aspect of the open transaction doctrine:

In situations involving sales of partial interests in unitary assets (like demutualization transactions and grants of easements on land in which the grantor retains the fee), basis allocation is the issue. The issue is whether the basis in the unitary asset can be apportioned reasonably between the interest sold and the interest retained. If so, the apportionment governs the computation of gain or loss on the sale. If not, the result is less clear. The *Fisher* court (as well as the courts in cases involving grants of easements and similar real property interests) allowed full basis recovery against the proceeds. Depending on the facts, however, IRS may be expected to argue (as it did in *Fisher—see also Gladden v. Commissioner*, 262 F.3d 851 (9th Cir. 2001)) that no basis should offset taxable gain, and that all the basis should be apportioned to the retained property interest.

By contrast, in a sale of a business or another entire asset for a contingent price, the issue is whether the value of the right to contingent sale price payments can be determined. If so, the transaction is subject to the closed transaction method or the installment method. If not, the transaction is eligible for the open transaction method. In situations involving gains, taxpayers will argue that the right to contingent sale price cannot be reasonably determined at the time of Closing, and that the open transaction method is available to defer the gain. If a loss is involved, taxpayers will argue that the right to contingent sale price can be reasonably determined at the time of Closing, so that the loss can be claimed immediately. Ultimately, the only relevance of the demutualization cases, as well as the easement cases, is the standard for determining whether the relevant factual conclusion can or cannot be reasonably determined.

(2) *Anschutz Co. v. Commissioner*

In *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), *aff'd* 108 AFTR 2d 2011-7590 (10th Cir. 2011), the taxpayer owned a block of publicly-traded stock that had appreciated in value. The taxpayer raised funds by entering into two agreements: a "prepaid variable forward contract" to sell the stock to a securities dealer 10 years in the future and a "share lending agreement." The dealer made an upfront cash payment to the taxpayer totaling 80% of the value of the stock; the taxpayer pledged and delivered the stock as collateral for the upfront payment and lent the stock to the dealer. The taxpayer was entitled to payments in lieu of dividends on the stock and was also entitled to retain 50% of any further appreciation on the stock above a threshold amount. The court held that the agreements, together, constituted a currently-taxable sale of the stock. *See also Calloway v. Commissioner*, 691 F.3d 1315 (11th Cir. 2012); *Sollberger v. Commissioner*, 691 F.3d 1119 (9th Cir. 2012); *Samueli v. Commissioner*, 661 F.3d 399 (9th Cir. 2011).

For our purposes, however, the interesting aspect of the opinion in *Anschutz* relates, not to the characterization of the transactions as a sale, but to the determination of the amount realized at Closing. IRS argued that the amount realized was the full value of the stock in a closed transaction—consisting of the upfront cash payment, the right to payments in lieu of dividends and the right to retain some appreciation (characterized by the government as an option). The Tax Court rejected this argument and held that the taxpayer's amount realized at Closing was limited to the upfront cash payment:

> Although certain portions of [taxpayer]'s contracts can be valued as equity options representing [taxpayer]'s entitlement to some appreciation in price and future dividends, whether petitioners will ever receive that value will not be determined until the contracts are settled. Further, as respondent's expert testified, the probability of the stock price's being above the downward protection threshold price is only 43 to 48 percent for [taxpayer]'s three transactions.
>
> Respondent's determinations, to the extent they treat petitioners as having received additional value in excess of the cash received, are incorrect. Accordingly, petitioners must recognize gain to the extent TAC received cash upfront payments in 2000 and 2001, which would include the 75-percent payment based upon the fair market value of shares and the 5-percent prepaid lending fee.

The court did not state that the future contingent payments were contingent sale price, or that the sale was an open transaction. Nor did the court state a conclusion as to the treatment of the contingent payments. The result of the court's analysis, however, seems to be that the sale was an open transaction, and therefore that any contingent payments would be taxed as additional sale proceeds and imputed interest upon receipt, and that the taxpayer was entitled to recover its full basis in the stock at Closing. The government did not appeal this conclusion, and the court of appeals did not address it.

g. Open Transaction Method – Sale for Private Annuity

For many years, a variant of the open transaction method was available to an individual who sold appreciated property for a private annuity on Seller's life. IRS guidance states that Seller's amount realized on the sale is the present value of annuity, based on annuitant's life expectancy, but that taxable gain is deferred and taxed ratably over Seller's life expectancy The restrictions on the installment method and the section 453A deferral charge do not apply. Rev. Rul. 69-74, 1969-1 CB 43. For an example, *see Katz v. Commissioner*, T.C. Memo. 2008-269.

In 2006, regulations were proposed to eliminate this benefit and tax sales for private annuities under the closed transaction method. The installment method would be available subject to normal exclusions and restrictions, including the deferral charge. As proposed, the regulations would take effect for sales after October 18, 2006, or, if specified conditions are satisfied, after April 18, 2007. Prop. Reg. § 1.1001-1(j) (2006). Notice of Proposed Rulemaking REG-14901-05 RIN 1545-BE92, 71 Fed. Reg. 61441 (Oct. 18, 2006). Even though no regulations have been adopted, the proposed retroactive effective date presumably has a chilling effect on these transactions. Guidance on this subject is an open project listed in the Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Tax Accounting ¶ 13.

D. Proposal to Replace Closed Transaction, Open Transaction and Installment Methods of Reporting Contingent Purchase Price

In a dissenting opinion in *Dorsey v. Commissioner*, 49 T.C. 606 (1966), Judge Simpson (with Judges Raum and Withey concurring) argued that the open transaction method should be available only to affect the timing of taxable income, not the character of the income as capital gain or ordinary income. He pointed out that, at the time *Burnet v. Logan* was decided, there was no capital gain preference.

Along the same line, a commentator has concluded that *Burnet v. Logan* provides only weak support for an open transaction method. J. Kwall, "Out With the Open Transaction Doctrine: A

New Theory for Taxing Contingent Payment Sales," 81 N.C. L. Rev. 977 (March 2003), discussed in part I.C.2.g., above. This commentator argues that earn-outs and similar arrangements should be treated as though Seller had sold part of its business and kept the rest, *e.g.*, as a partnership interest. This treatment would replace both the open and closed transaction methods and the installment method too. The main results would be that (i) no gain or loss would be recognized on the portion of the business deemed retained; (ii) the basis of that portion of the business would not be taken into account in the sale; (iii) the contingent payments (presumably, less the remaining basis) would be ordinary income to Seller when accrued or received; (iv) the contingent payments would be excluded from Acquiror's income; and (v) all of Seller's basis in the portion of the assets sold would be recoverable against the fixed sale price. It is not clear how such a system would work in the case of a stock sale or as to assumptions of contingent liabilities.

E. Treatment of Acquiror

From Acquiror's perspective, an acquisition involving a contingent purchase price is always accorded open transaction treatment – to Acquiror's disadvantage. It makes no difference whether Seller uses the installment method or elects out and uses the closed or open transaction method. Acquiror gets asset basis for contingent payments later, when the contingent payments become fixed in amount or are actually made. Reg. §§ 1.461-1(a)(1) and (2).

1. Allocation of Contingent Purchase Price Among Assets Purchased

Under section 1060, Acquiror's consideration paid is the cost of the assets acquired in the applicable asset acquisition. Reg. § 1.1060-1(c)(1).

a. Increases in Purchase Price

Additional payments are allocated among the transferred assets, but only up to the fair market value of the assets, and so the payments tend to make their way to Class VII assets (goodwill). Reg. § 1.1060-1(c)(2).

b. Decreases in Purchase Price

Purchase price decreases are allocated in reverse order, starting with Class VII. Reg. §§ 1.338-6(b) and 1.338-7, cross-referenced in Reg. § 1.1060-1(c)(2). *See* part II.C.3., below.

2. Specific Allocations – Intangible Assets

Under the original section 338 regulations, in a section 338(h)(10) stock sale if the specific allocation of an increase or decrease in consideration resulted from a contingency directly related to a particular intangible asset (such as a patent, secret process, or copyright), the adjustment could be specifically allocated to the basis of that intangible, up to its fair market value (re-determined at the time the increase or decrease is taken into account). Old Reg. §§ 1.338(b)-3T(g) and 1.1060-1T(f)(4). The current regulations eliminate this feature as a simplification measure. 64 Fed. Reg. 43,461, at 43,470 (Aug. 10, 1999), discussed in part II.C.2.d., below.

3. Interest

When a contingent payment of purchase price is made, the payment is apportioned between principal and interest. Acquiror discounts the payment using the same section 483 or section 1274 rules that apply to Seller, and Acquiror deducts the interest portion. *See* parts I.C.2.b. and c., above. This interest is deductible only when the amount of stated or imputed interest becomes fixed (accrual method) or when paid (cash method). Reg. § 1.461-4(e). On the accrual method, interest can be deducted even before economic performance on the principal portion of the contingent payment—*i.e.*, before the principal can be added to the basis of the purchased assets. Interest is generally not capitalized. An exception in section 263(g) applies only to straddles. If the assets acquired are not publicly-traded property, there can be no straddle, and the interest component is not capitalized. Section 1092(d)(1).

4. Timing of Adjustments to Basis of Acquired Assets

Acquiror is entitled to make an upward basis adjustment only upon making an additional purchase price payment to Seller. Reg. §§ 1.461-1(a)(1) and (2). Because the "space beneath" the fair market value cap of the Class II to Class V assets is likely to have been filled, the increased basis adjustment generally will be made to intangibles (Classes VI and VII), recoverable over the remainder of the 15-year amortization period from the date of sale.

5. Contracts for Use of Intangibles

Section 197, requiring 15-year straight-live amortization for acquired intangible assets does not apply to amounts that are otherwise deductible. Reg. § 1.197-2(a)(3). Pre-section 197 case law suggested that, to the extent the price paid for certain types of intangible assets pertains to a particular taxable year, the amounts paid are deductible in that year. *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*, Acquiror could claim an immediate deduction for purchase price payments tied to performance of the intangible during the taxable year, irrespective of the 15-year amortization period under section 197. The section 197 regulations eliminate this argument, with certain exceptions. Reg. § 1.197-2(b)(11) includes in the definition of "section 197 intangible" licenses, contracts, etc., for the use of section 197 intangibles. Reg. § 1.197-2(f)(3) goes on to provide that amounts paid for the use of intangibles generally are not deducted currently but are instead amortized over 15 years. *See* part II.C.2.c., below.

6. Restructuring of Target in All Cash Type-D Reorganization After Stock Sale

If Acquiror buys Target stock from Seller, Acquiror's basis in the Target stock does not include any contingent purchase price until fixed or paid. Suppose that, in the meantime, Acquiror causes Target to be merged into X, another Acquiror subsidiary, for cash. The merger is an all-cash type-D reorganization (Treas. Reg. § 1.368-2(l)(2)). If Acquiror and Target are not members of a U.S. consolidated group, Acquiror recognizes boot gain, measured using Acquiror's basis in the Target stock, which does not reflect any obligation to pay contingent purchase price.

If sufficient earnings and profits are available, the cash would be taxed as a dividend under section 356(a)(2) (dividend-within-gain). If, after the merger, Acquiror pays the contingent purchase price to Seller, may this dividend be offset by a loss under *Arrowsmith*? No precedent seems to allow such a loss, and the better technical answer seems to be that Acquiror would be entitled only to increase its basis in its X stock.

If no earnings and profits are available, the gain would be taxed as capital gain under section 301(c)(3). In this case, it seems more likely that, under *Arrowsmith*, the capital gain would be offset by capital loss. *See* Reg. § 1.1001-2(a)(3), also discussed in part X.F., below. The answer is, however, far from clear.

7. Payment to Third Party

PLR 201027035 (Mar. 31, 2010) presents the unusual situation of a contingent purchase price payment by Acquiror to a third party (not a payment of an assumed liability). Seller sold the stock of Old T to Acquiror with a section 338(h)(10) election. As part of the consideration, New T agreed to pay to Seller a percentage of tax benefit from the stepped-up basis resulting from the deemed asset purchase. Later, Seller assigned part of its rights to the payments under this "Tax Agreement" to Y, and New T settled its obligations under the Tax Agreement for a cash payment to Y. The ruling does not state whether the underlying section 338(h)(10) sale was a closed or open transaction to Seller, but it recites as a fact that, under the Tax Agreement, the payments were computed to take into account an increase in asset basis resulting from the payments thereunder. IRS ruled only that New T did not realize cancellation-of-debt income from settling its Tax Agreement obligations for the fixed payment to Y.

F. Allocation of Amount Realized Among Assets Sold

1. Section 1060

For purposes of determining both Seller's amount realized and Acquiror's basis in the purchased assets, the total selling price, including the contingent payment, is allocated among all assets, tangible and intangible. Under section 1060, if the transaction is open, increases in consideration are allocated among assets under the residual method, and decreases in consideration are allocated in reverse section 1060 order: first to goodwill (Class VII), then to other intangibles (Class VI), etc. Reg. §§ 1.338-6(b) and 1.338-7, cross referenced in Reg. § 1.1060-1(c)(2). (For methods of citing various versions of regulations under sections 338 and 1060, *see* part II.A., below.) Section 1060 applies if Acquiror'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").

2. Commissioner v. Danielson

It is common for Seller and Acquiror to agree on allocations of purchase price, in order to prevent controversy with IRS. Even if a purchase price allocation complies with section 1060, IRS may require both parties to use the agreed allocation if there is one. Under the rule in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967) (endorsed in the legislative history to section 1060), the parties must follow the agreed allocation unless the agreement itself is invalid under substantive contract law, but IRS is not bound by the allocation. In a recent case, the Tax court applied the Danielson rule to prevent Acquiror from subdividing portions of purchase price, allocated to buildings in the agreement, among components of the building. *Peco Foods, Inc. v. Commissioner*, T.C. Memo. 2012-18. This loss of flexibility after Closing should cause the parties, especially Acquiror, to consider whether an agreed purchase price allocation is in fact advantageous.

G. Possible Treatment of Contingent Purchase Price as Target Stock, Acquiror Stock or Partnership Interest

Depending on its terms, a right to contingent purchase price payments could be treated as stock of the Acquiror or a partnership interest, or as stock of the Target retained by the Seller, especially if the contingent purchase price is tied to factors that affect the value of the business.

If, in the case of a sale of Target stock, as opposed to assets (deemed or otherwise), a right to contingent purchase price is treated as Target stock, Seller would be treated as retaining this stock. If so, as contingent payments are made, the payments would be treated as redemptions of this stock, taxed as sale proceeds or as dividends under section 302, If the redemptions are taxed as sales under section 302, this treatment would be similar to installment sale treatment, because the deemed redemption payments would be taxed as received with recovery of the basis of the redeemed stock.

Perhaps more important, this deemed retention of Target stock could involve a trap for the unwary. That is, it could render a section 338(h)(10) or section 336(e) election unavailable, by preventing the transaction from being a "qualified stock purchase" under section 338(d)(3) (80% or more of vote and value must be acquired by corporate purchaser within a 12-month period) or a "qualified stock disposition" under Reg. § 1.336-1(b)(6) (80% or more of vote and value must be disposed of within a 12-month period). In addition, if the sale is followed by a liquidation or merger of Target, the step transaction doctrine could be applied to change the character of the liquidation from tax-free to taxable or vice versa. *See, e.g.*, Rev. Rul. 2001-46, 2001-2 CB 321.

Also in the case of a sale of Target stock, a contingent payment obligation could be treated as a new class of Target stock that is (i) received by Seller in exchange for some of the historically-owned Target stock, in a tax-free recapitalization and (ii) retained when Seller sells the rest of the Target stock. This treatment would prevent Seller from having to include the value of the contingent purchase price in its amount realized at Closing. The contingent payment feature should prevent this "stock" from being nonqualified preferred stock (section 351(g)), taxable on receipt under section 354(a)(2)(B).

Treating the contingent payment right as Acquiror stock would eliminate the open transaction method. Conceivably, it could convert the sale to a tax-free reorganization.

The installment method does not apply to a contingent purchase price obligation that represents a retained interest in the property, an interest in a joint venture or partnership or equity in a corporation. Reg. § 15a.453-1(c)(1); *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976) (no joint venture when Seller indemnified Acquiror for earnings shortfall). *See also TIFD III-E Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012) (purported partnership interest disregarded).

H. Reporting Requirements

1. Section 1060 Asset Sales

In an asset sale, Seller and Acquiror each must complete Form 8594, Asset Acquisition Statement Under Section 1060 (Rev. Feb. 2006), 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 parties must complete Part I and the supplemental statement in Part III of a new Form 8594 (allocating and explaining the reasons for the price increase or decrease) and attach it to the return for the year in which the increase or decrease is taken into account.

Seller and Acquiror need not agree on the allocation of the purchase price. *See* part I.F.2., above. In fact, where there is contingent price, Seller and Acquiror will have different prices due to the inconsistency between Seller's closed transaction treatment and Acquiror's open transaction treatment. Other differences arise due to the parties' transaction costs. Seller's costs reduce its amount realized, and Acquiror's costs increase its basis.

2. Stock Sales with Elections under Section 338(h)(10) or Section 336(e)

See part II.D., below.

3. Installment Method

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

4. Election Out of Installment Method

To elect out of the installment method, Seller reports the full amount of gain on a timely filed return (including extensions), using Form 4797, Sales of Business Property, or Schedule D for individuals. There is no specific procedure for electing out where the installment method applies only by virtue of assumption of contingent liabilities, or where the open transaction method is available.

II. Contingent Purchase Price and Contingent Liabilities in Stock Acquisitions with Section 338(h)(10) and Section 336(e) Elections – Current Regulations

A. Introduction

1. Section 338

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 distributed the sale price to Seller, generally in liquidation.

This part II. discusses the current section 338(h)(10) regime that was first adopted in temporary regulations during January 2000. TD 8858, 65 Fed. Reg. 1236 (Jan. 7, 2000). The temporary regulations were based on and closely resembled proposed regulations published in August 1999. Notice of Proposed Rulemaking REG-107069-97, RIN 1545-AZ58, 64 Fed. Reg. 43,461 (Aug. 10, 1999). The temporary regulations revised all the regulations under section 338 (other than those dealing with international matters and with asset and stock consistency) and section 1060, effective for qualified stock purchases after January 5, 2000. TD 8858, 65 Fed. Reg. 1,236 (Jan. 7, 2000). The final section 338 regulations, which closely followed the temporary regulations, were adopted in February 2001 effective for transactions after March 16, 2001. TD 8940, 66 Fed. Reg. 9,925 (Feb. 13, 2001), corrected, 66 Fed. Reg. 17,362 (March 30, 2001).

Part II*., below, discusses the section 338(h)(10) and section 1060 regime under the regulations in effect before the temporary regulations (cited as "Old Reg. §"). Most commentators had concluded that, in a section 338(h)(10) transaction under these prior regulations, (1) the installment method was not available, but (2) if there was contingent purchase price or an assumption of contingent liabilities, open transaction treatment was allowed for Old T as well as being required for New T.

The preamble to the proposed regulations states the major purposes of the new regulatory scheme. Substantively, the most important change was that, with limited and specific exceptions, a section 338(h)(10) stock sale is treated as though the asset sale and distribution to Seller had actually occurred.

As applied to sales with contingent purchase price (including assumption of contingent liabilities), the final section 338 regulations adopted significant changes on the Seller/Old T side: The installment method can be used, but open transaction treatment is restricted as in actual asset sales. On the Acquiror side, the final section 338 regulations eliminated the phantom income that could occur in the prior asset classification system by adding two new asset classes, and also eliminated the rule that allowed special allocation of contingent payments to the basis of intangible assets.

2. Section 336(e)

Section 336(e) was added to the Code in 1986 as part of the General Utilities repeal. It authorizes the issuance of regulations under which an election may be made to treat a sale, exchange or distribution of at least 80% of the stock of a subsidiary (by both vote and value) by its corporate parent as a sale of the subsidiary's assets, in addition to the elections under section 338.

On August 25, 2008, IRS and Treasury issued proposed regulations under section 336(e). 73 Fed. Reg. 49965. Final regulations were adopted on May 10, 2013 (TD 9619), effective for "qualified stock dispositions" on or after May 15, 2013. These regulations expand the scope of elective deemed asset sale treatment to cover taxable "dispositions" or series of dispositions by a domestic parent of stock of a domestic subsidiary if the total stock disposed of, to one or more unrelated persons within 12 months, satisfies section 1504(a)(2) (at least 80% measured by vote and value). These regulations are modeled on the section 338(h)(10) regulations. The treatment of contingent purchase price and contingent liabilities in a stock disposition subject to a section 336(e) election is identical to their treatment under section 338(h)(10). For this reason, the section 336(e) regulations are not discussed extensively in this outline.

Reg. § 1.336-2(h) provides the general rule for making a section 336(e) election, with requirements depending on whether Seller and Target are members of the same consolidated group, whether Target is an S corporation, and whether the Target is a lower tier subsidiary of a Target. The election generally requires a binding, written agreement to make the election and attaching an election statement to the relevant tax returns of Seller and/or Target. Old T and New T must report information concerning the deemed sale of Target's assets on Form 8883, with adjustments. A separate section 336(e) election statement required for each target subsidiary.

B. Treatment of Old T

1. Installment Method

The installment method is available in the asset sale that is deemed to occur in a stock sale with a section 338(h)(10) or section 336(e) election. Reg. §§ 1.338(h)(10)-1(d)(8), 1.336-1(a) and 1.336-2(b)(1)(i)(B)(1). The overriding principle of section 338(h)(10) is that the transaction is treated as though it were an actual asset sale and liquidation. Reg. § 1.338-1(d)(3). Old T may not assert any position inconsistent with this principle. Reg. § 1.338(h)(10)-1(d)(9). In turn, the overriding principle of the section 336(e) regulations is that "the results...should coincide with those of section 338(h)(10)." Reg. § 1.336-1(a).

a. Acquiror's Installment Note

Old T is treated as selling its assets to New T for an installment note issued by the purchaser of the Target stock as though it were New T's obligation. Reg. § 1.338(h)(10)-1(d)(8)(i). This treatment eliminates the technical bar to the installment method that existed in the prior section 338 regulations (*i.e.*, the fact that the note is actually issued by the stock purchaser, Acquiror, not by the deemed asset purchaser, New T—*see* Reg. § 15a.453-1(b)(3)(i)).

b. Other Consideration Deemed Paid to Old T

All other consideration received by Old T in the asset sale is deemed paid in cash. For example, if Acquiror does not purchase all the Target stock, New T still is deemed to purchase all the assets of Old T. The excess of the deemed purchase price for the assets over the amount actually paid for the stock is deemed paid in cash. This rule also applies to assumed liabilities of Old T shareholders, but it does not apply to assumed liabilities of Old T itself. Reg. § 1.338(h)(10)-1(d)(8)(i). This exclusion suggests that a deemed assumption by New T of a contingent liability of Old T turns the deemed asset sale into an installment sale. *See* part I.B.3d.(5), above, and part IV.D., below.

c. Other Rules

The installment method applies as in an actual asset sale. For example, the rule that prohibits secured borrowing in contemplation of the sale and the rules deferring asset basis recovery and the deferral charge under section 453A both apply. 64 Fed. Reg. 43,462 at 43,471 (Aug. 10, 1999). *See* part I.B.5., above, discussing the harsh application of the deferral charge to contingent purchase price. Although not referred to, the rule postponing loss recognition in an installment sale with contingent purchase price presumably applies as well. Reg. §§ 15a.453-1(c)(2)(iii) Example (5), 15a.453-1(c)(3)(i).

d. Deemed Distribution of Acquiror's Installment Note

The installment obligation is treated as distributed by Old T to Seller. If there is more than one Old T shareholder, the installment obligation is treated as distributed to the shareholders in the same amount they actually receive in the stock sale. Reg. § 1.338(h)(10)-1(d)(8)(ii).

e. Possible Immediate Gain Recognition for S Corporation Shareholders

The most important part of the section 338 regulations relating to the installment method is an example dealing with an S corporation. Reg. § 1.338(h)(10)-1(e) Example 10 shows that, if some Target shareholders receive cash and others receive installment notes, there is some immediate gain recognition in the deemed asset sale, but installment sale treatment remains in effect notwithstanding the deemed liquidation of Old T. The most important point illustrated by the example is that, even if a particular Target 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 rules nor the example deals explicitly with contingent purchase price or contingent liabilities under the installment method. In an actual asset sale under the installment method, Old T recognizes gain and recovers basis as the contingent payments are received. *See* part I.B.3., above. If Old T is an S corporation, this gain is passed through to the shareholders and causes adjustments in the basis of the Old T stock and in the gain recognized to the shareholders in the deemed liquidation.

2. Election Out of Installment Method

As in an actual asset sale, the installment method applies unless Old T is ineligible for the installment method or elects out. 64 Fed. Reg. 43,462 at 43,471 (Aug. 10, 1999); *see* part I.B.2., above. Because of the possibility that any sale with a contingent liability could be eligible for the installment method (*see* part I.B.3.d.(5), above, and part IV.D., below), and because the installment method would delay full basis recovery, an election out should be made if Seller does not wish to use the installment method.

a. Closed Transaction Method

(1) Amount Realized and Gain or Loss Recognized at Closing

If Old T elects out of the installment method, Old T reports 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.C.2., above. Although the regulations do not explicitly so state, the preamble to the proposed section 338 regulations describes this change as "breaking the link" between deemed Seller (Old T) treatment (ADSP) and deemed Acquiror (New T) treatment (AGUB). 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). *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 and report either gain or loss based on normal closed transaction principles. Old T's treatment, however, remains uncertain: Must Old T determines the fair market value of New T's deemed assumption of Old T's contingent liabilities and treat this value as amount realized at Closing, or may Old T take contingent liabilities into account later? In either case, is Old T entitled to a deduction for the assumption of its contingent liabilities and their payment by New T and, if so, when is this deduction allowed? *See* parts II.B.2.d. and IV.D., below.

(2) Amount Realized and Gain or Loss Recognized Upon Receipt of Contingent Purchase Price

A contingent purchase price obligation deemed paid to Old T by New T is separate property with a basis in the hands of Old T (and then to Old T's shareholders after Old T's deemed liquidation). *See* part I.C.2.e. through part I.C.2.g., above.

- One way to analyze this situation is that, when the contingent purchase price is accrued or paid, principal amounts, discounted from the date of sale, are treated as proceeds from this obligation. Once the basis in the obligation has been recovered (or not), Old T recognizes gain or loss. This gain or loss may be either capital gain or loss or ordinary income or loss. *See* parts I.C.2.e. through I.C.2.g., above. The balance of the payments is interest income to Old T at the AFR or at a higher agreed-upon rate.
- The alternative analysis is to treat the contingent purchase price as an adjustment to the amounts received in the deemed asset sale (ADSP under section 338(h)(10) and ADADP under section 336(e)), 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, contingent purchase price would relate back to the day after the acquisition date, for both ADSP and AGUB purposes. Reg. §§ 1.338-4(b)(2)(ii), 1.338-5(b)(2)(ii).

The regulations do not state which analysis applies. The preamble to the proposed section 338 regulations states that "general principles of tax law" apply in connection with contingent items. The regulations treat section 338(h)(10) and section 336(e) stock sales like actual asset sales and eliminate the special "fixed and determinable" rule in the prior section 338 regulations (Old Reg. § 1.338(b)-3T(c)). 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). Thus, the general "closed transaction" rule for asset sales applies under sections 338(h)(10) and 336(e) as well.

b. Open Transaction Method

In the "rare and extraordinary cases" where the contingent purchase price cannot be valued, Old T may use the open transaction method and so have amounts realized only upon receipt or accrual and recover its full basis in the assets up front, as payments are received or accrued, subject to interest imputation. *See* part I.C.3., above.

c. Amount Realized and Gain or Loss Recognized Upon Fixing or Payment of Target's Contingent Liabilities

No authority states whether assumption of contingent liabilities in an actual or deemed asset sale must be valued and taxed to Old T as amount realized at Closing, like contingent purchase price. Reg. § 1.1001-1(g)(2)(ii) includes contingent "debt instruments" in amount realized, but it is not clear whether this term includes assumption of contingent liabilities. Reg. § 1.1001-2(a)(3) provides that an assumption of a liability is not included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis for such property." But this exclusion applies only to "a liability incurred by reason of the acquisition of the property"—presumably an earlier "acquisition of the property" by Old T. Still, this provision could be read to suggest a deferral for assumption of contingent liabilities not yet taken into account at the time of Closing. *Cf.* sections 357(c)(3), 358(d) discussed in part X.A., below. In *Crane v. Commissioner*, 731 U.S. 1 (1937), the Supreme Court held that the amount realized on a sale of property includes the principal balance of a mortgage to which the property is subject, but the Court agreed with the Commissioner that accrued but unpaid interest was not included (Seller was on the cash method), because the interest would be deducted when paid. Does this conclusion mean that an assumption of a contingent liability is not included in amount realized at Closing because it will be deductible to Seller when paid by Acquiror? Probably not. The Commissioner probably excluded the interest in *Crane,* because the deduction would offset the amount realized. In addition, the rule that there is no imputed interest or original issue discount implies that no valuation or inclusion in amount realized at Closing of contingent liability assumption is required. This seems to be the better answer. If contingent liabilities need not be valued at Closing, then, even in an otherwise closed transaction (*see* part II.B.2.b., above), the accrual or payment of contingent liabilities will result in ADSP adjustments (*see* parts II.B.2.b., above, and part IV.D., below).

Payment of the liability should result in an offsetting deduction to Old T. *See* parts II.B.4.c. and IV.D.2.a., below.

d. Taxation of Amounts Realized upon Receipt of Contingent Purchase Price or Fixing or Payment of Target's Contingent Liabilities

(1) Background

As discussed in part II.B.2.a., above, 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 obligation and recognize gain or loss (as well as interest income) on the obligation. As discussed in part II.B.2.b., above, in a "rare and extraordinary" open transaction with contingent purchase price, Old T will recognize gain or recover basis (and, again, receive interest income) only upon accrual or receipt of the contingent purchase price amounts. As discussed in part II.B.2.c., above, where assumed contingent liabilities accrue or are paid later, there may be additional amount realized on the deemed asset sale and offsetting deductions. If the Seller of the Target stock must return part of the sale price (*e.g.*, for an indemnity), there will be a reduction in the ADSP.

(2) Taxation

Gain from an open transaction, gain and offsetting deductions from later accrual of contingent liabilities and loss from return of purchase price all are included in the concept of "deemed sale tax consequences" discussed in part II.B.4.c., below. They are taxed to (or deductible by) Old T even if Target itself has ceased to exist (and even though Old T usually will be deemed liquidated under section 338(h)(10) or section 336(e)). The additional gain, loss or deduction is accounted for by the Old T shareholders in the year in which the adjustment occurs. Reg. §§ 1.338-7(c)(1), (c)(3). The section 336(e) regulations contain several cross-references to Reg. § 1.338-7.

(3) Treatment of Tax Liability

Unlike the prior section 338 regulations (which assume that Old T's shareholders will pay this tax), the current regulations, in effect, require the parties to allocate tax liability resulting from the deemed asset sale between themselves. According to the preamble, 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 like any other liability:

> Commentators asked for further clarification of the standards for taking certain taxes into account. Rather than providing more specific guidance, which would be inconsistent with the overall philosophy of deferring to general tax principles governing actual transactions, the final regulations further simplify the discussion of liabilities. Except for the fact that new target remains liable for old target's tax liabilities (see section 1.338-1(b)(3)(i)) and that a buyer's assumption of a seller's income tax liability with respect to the sale causes the consideration to "gross up" or "pyramid," a tax liability is like any other type of liability and the status of any particular type of tax liability as a liability includible in ADSP or AGUB should be determined under general principles as applied to the facts relating to the incidence of the tax liability.

TD 8940, 65 Fed. Reg. 9,925 at 9,926 (Feb. 13, 2001). *See* also Reg. §§ 1.338-4(d)(1), (e); 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). In any event, New T remains liable to IRS for all of T's Federal income tax, including tax resulting from the deemed asset sale. Reg. §§ 1.338-1(b)(3)(i), 1.338(h)(10)-1(d)(2) and 1.336-2(b)(1)(ii). *See* part II.D.2., below. Thus, Acquiror should be sure that the selling T shareholders indemnify it for tax liability from purchase price adjustments.

3. Allocation of Amounts Realized Among Assets Deemed Sold

Old T's amount realized 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 is considered paid first for cash and cash equivalents (Class I), then actively-traded personal property (including 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). Reg.

§§ 1.338-6(b), 1.1060-1(c)(2). Later adjustments in the purchase price would result in readjustments to this allocation. Reg. §§ 1.338-4(b)(2)(ii); 1.338-7(b). The same rules apply under section 336(e).

4. Character of Amounts Realized

a. Contingent Purchase Price

A contingent purchase price obligation is treated as a separate contingent obligation owed by New T to Old T. The parties 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 is 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 is interest. It is not clear whether the principal payments result in ordinary income (or loss) or capital gain (or loss). *See* parts I.C.2.e. through g., above.

b. Contingent Liabilities – Gain

The regulations avoid any specific rule for contingent liabilities but rather state that contingent liabilities are taken into account as though there had been an actual asset sale. Reg. §§ 1.338-4(d)(2) (ADSP), 1.338-5(e)(2) (AGUB). Again, the same rules apply under section 336(e). Under these principles, there is no imputed interest on these amounts. *See* parts II.B.2.d., above, and IV.D.1.a.(2), below.

c. Contingent Liabilities – Deductions

The proposed section 338 regulations introduced a new all-purpose term—"deemed sale gain"—to include all of Old T's tax consequences from a deemed asset sale. The preamble commented 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.

64 Fed. Reg. 43,462 at 43,467 (Aug. 10, 1999). This passage confirmed the general treatment of offsetting amount realized and deduction when an otherwise-deductible or capitalized contingent liability becomes fixed or is paid. The final regulations substitute the more descriptive term, "deemed sale tax consequences" for the same concept.

C. Treatment of New T

From New T's perspective, a deemed asset purchase involving contingent consideration (whether contingent purchase price or assumption of Old T's contingent liabilities) is accorded open transaction treatment, as in an actual asset purchase. *See* part I.C.3., 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 section 461(h) economic performance rules delay inclusion of these amounts in New T's asset basis. 64 Fed. Reg. 43,462 at 43,465 (Aug. 10, 1999). The Court of Federal Claims recently so held in *AmerGen Energy Co. LLC v. United States*, 112 AFTR 2d 2013-6376 (Ct. Fed. Cl. 2013) (appeal pending).

1. Allocation of Contingent Purchase Price and Contingent Liabilities Among Assets Deemed Purchased

The rules for actual asset acquisitions apply to stock acquisitions with elections under section 338(h)(10) and section 336(e).

2. Timing of Effects on Basis

The same rules apply to section 338(h)(10) and section 336(e) stock sales as to actual asset acquisitions. *See* part I., above.

a. Upward Basis Adjustments

Upon making a purchase price payment to Old T or accruing or paying an assumed contingent liability, New T is entitled to make an upward basis adjustment. Reg. §§ 1.338-7(b), (d); Reg. § 1.197-2(f)(2)(i). Again, the same rules apply under section 336(e).

b. Recovery Methods and Periods

New T allocates each payment among the purchased assets in the order described in Reg. § 1.338-6(b). *See* part II.B.3., above, and part II.C.3., below. New T adjusts basis in depreciable property and takes 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 regulations refer to general principles of tax law. Reg. §§ 1.338-7(c)(3). Presumably, under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952), New T recognizes loss in this situation. Again, the same rules apply under section 336(e).

c. Recovery Methods and Periods – Contracts for Use of Intangibles

The regulations under section 197 eliminate the argument that amounts paid for the use of intangibles can be deducted instead of amortized. Reg. §§ 1.197-2(a)(3), (b)(11), (f)(3)(ii) and (g)(6). But there are exceptions, including the following:

(1) No Acquisition of a Trade or Business

Payments for a right to use intangibles which are not part of an acquisition of a trade or business fall outside of section 197 amortization. Reg. §§ 1.197-2(f)(3)(ii)(A), (f)(3)(iii). The basis of a right to a fixed amount is amortized for each taxable year. The amount of amortization for each year is the basis of the right, multiplied by a fraction, the numerator of which is the amount received during the taxable year and the denominator of which is the total amount to be received under the contract. Reg. § 1.167(a)-14(c)(2)(ii). If amount to be received is unspecified, but the duration of the right is shorter than 15 years (including all reasonably expected renewals), then the payment is amortized ratably over that period. Reg. § 1.167(a)-14(c)(2)(ii).

Payments which are part of an acquisition of a trade or business, on the other hand, are subject to section 197. Reg. § 1.197-2(k) Example 5. (*See also* Reg. § 1.197-2(c)(7), providing that interests in patents and copyrights not acquired as part of an acquisition of a trade or business are not section 197 intangibles, and Reg. § 1.167-14(c)(4), providing rules for amortizing payments for such interests.)

(2) Exception to Acquisition of Trade or Business

As a related matter, the regulations provide that an acquisition of a franchise, trademark or trade name is not per se an acquisition of a trade or business (reversing the rule in the proposed regulations), if under section 1253 principles there is no acquisition of all substantial rights (or an undivided interest in all substantial rights) in a trademark or trade name. Reg. § 1.197-2(e)(2)(ii)(C). This new rule allows a broader category of payments to fall outside of section 197 amortization.

(3) Section 1253(d)(1) Payments

Payments for a franchise, trademark or trade name subject to section 1253(d)(1) (contingent serial payments) are deductible, not amortizable under section 197, even if made as part of an acquisition of a trade or business. Reg. §§ 1.197-2(b)(10)(ii) and 1.197-2(k) Example 5.

(4) Exception for Information Base

There is a special exception for payments on licenses of most types of "information base" (*e.g.*, technology, know-how, etc.). These payments may be deducted currently if they are arm's length and there is no "sale or exchange" under section 1235 (*i.e.*, the payments would have been deductible under pre-section 197 case law). The "sale or exchange" issue under section 1235 will receive "close scrutiny." Reg. §§ 1.197-2(f)(3)(ii)(B), (f)(3)(iii) and 1.197-2(k) Examples 7-10. *See also* Reg. § 1.167(a)-14(b) (36 month amortization for publicly available computer software).

(5) Timing of Amortization; Deductions for Imputed Interest

If a payment for use of an intangible is capitalized, the amount capitalized is discounted as though it were a debt instrument. This rule allows a portion of the payments to be deducted currently as imputed interest. Reg. §§ 1.197-2(f)(2)(i), (f)(2)(ii), (f)(3)(iv)(B) and 1.197-2(k) Examples 6 and 9. Also, as payments are made (or become fixed) and are added to basis, the non-interest portion is amortized over the remaining 15-year amortization period for the intangible (or, if made or fixed after the end of the 15-year period, is deductible currently). Reg. § 1.197-2(f)(2)(iii).

d. Elimination of Special Purchase Price Allocation

As a simplification measure, the current regulations eliminate the rule allowing contingent payments to be allocated to specific intangible assets. Old Reg. § 1.338(b)-3T(g). IRS had requested comments on this point when this change was proposed. 64 Fed. Reg. 43,462, 43,470 (Aug. 10, 1999).

3. Elimination (Mostly) of Phantom Income

An important Acquiror-side feature is the addition of separate asset classes for receivables (new Class III) and inventories (new Class IV). Adding these two new asset classes ahead of the "everything else" class (old Class III, new Class V) means that, in a bargain purchase, receivables and inventories are more likely to attract basis equal to their full fair market value and not share basis with other assets. This change prevents phantom income from being taxed when purchased receivables are collected or inventories sold. 64 Fed. Reg. 43,462, 43,469 (Aug. 10, 1999). Although this change is not specifically related to contingent purchase price or contingent liabilities, it is especially apt to be relevant in situations where Acquiror assumes large contingent liabilities, or where indemnity payments by Seller to Acquiror reduce the purchase price. Some practitioners have expressed concern that the new asset classes are too narrow, and that the descriptions of these new classes are not clear enough.

Phantom income can still occur:

- A dramatic example occurs in acquisitions of nuclear power stations, which are subject to liability for decommissioning costs, which are funded with trust funds. *See* part IV.D.2.b.(4), below.
- An acquisition of tiered target corporations subject to elections under section 338(h)(10) or section 336(e) can also create a phantom income problem. The stock of a subsidiary is a class V asset, if section 338(h)(10) or section 336(e) elections are made for both parent and subsidiary. (This mechanism is referred to as "top down.") 64 Fed. Reg. 43,462, 43,473-74 (Aug. 10, 1999). If significant contingent liabilities are assumed, the basis available to be allocated to the stock of the subsidiary may be less than its value, and this limitation will push down to the basis of the subsidiary's assets.

4. "Breaking the Link" Between ADSP and AGUB

The regulations confine open transaction treatment for Old T to "rare and extraordinary" cases (*see* part II.B.2.c., above). On the New T side, however, the regulations continue to require open transaction treatment. In most situations involving contingent purchase price, the results will be completely inconsistent treatment as between Old T and New T.

a. Old T's Treatment

Old T values New T's contingent purchase price obligation, treats this value as taxable amount realized on the sale, and sets up a debt instrument or contract as a separate asset, with a basis equal to this value. As payments accrue or are received, they are treated as part interest (taxable) and part payments on this debt instrument (return of basis, then gain or loss). There are no adjustments to ADSP for these amounts.

b. New T's Treatment

New T does not value its contingent purchase price obligation or set up any debt instrument at Closing. Its basis in the Target assets excludes the contingent payment obligation. As payments accrue or are received, they are treated as part Interest (deductible) and part payments for the assets (added to AGUB and asset basis).

c. Inconsistency

The inconsistency of treatment between Seller and Acquiror is intentional, in the sense that IRS and Treasury determined that stock sales subject to elections under section 338(h)(10) or section 336(e) should be treated under existing law governing asset sales. 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). Taxpayers may be expected to engage in self-help to avoid whipsaw. Steps may include (i) Seller claiming open transaction treatment because the contingent purchase price obligation cannot be valued, (ii) Seller claiming closed transaction treatment but low fair market value for the contingent purchase price obligation, and (iii) using escrows in lieu of contingent purchase price obligations (*see* part III., below).

D. Reporting and Administrative Requirements

1. Election

a. Section 338(h)(10)

Acquiror and Seller (or Seller's consolidated group) make a section 338(h)(10) election jointly by filing a completed Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases (Rev. October 2002). The form must be filed no later than the 15th day of the 9th month beginning after the acquisition date (*i.e.*, often before the return for that year is due). Reg. § 1.338(h)(10)-1(c)(2).

b. Section 336(e)

Under Reg. § 1.336-2(h), section 336(e) election requirements depend on whether Seller and Target are members of the same consolidated group, whether Target is an S corporation, and whether the Target is a direct or lower-tier subsidiary of Target (target subsidiary). The election generally requires a binding, written agreement to make the election between Seller and Target and attaching an election statement to the relevant tax returns of Seller and/or Target.

If consolidated, Seller and Target enter into a written, binding agreement on or before the due date of the group's consolidated return for the year that includes the disposition date, and the common parent retains a copy of the agreement, attaches a section 336(e) statement to the group's return for that year and provides a copy of the election statement to Target on or before the due date of that return.

If affiliated but not consolidated, Seller and Target enter into a written, binding agreement on or before the due date of the earlier of Seller's or Target's return for the year that includes the disposition date; and each retains a copy of the agreement and attaches a section 336(e) election statement to its return for the taxable year that includes the disposition date.

If Target is an S corporation, all the shareholders (including those who do not dispose of their stock) and Target enter into a written, binding agreement on or before the due date of Target's return for the year that includes the disposition date; and Target retains a copy of the agreement and attaches a section 336(e) election statement to its return for that taxable year.

A lower- tier Target must meet the written, binding agreement requirement, but it can be included in the parent Target's agreement; or there can be a separate agreement for the tiered Target. Separate section 336(e) election statement required for each target subsidiary.

2. Additional Filing Requirements

a. Section 338(h)(10) Election

In contrast to an actual sale of assets, no Form 8594 need be filed in a stock sale with an election under section 338(g), section 338(h)(10) or section 336(e). The preamble to the section 338 regulations states that, in revising Forms 8023 and 8594, IRS and Treasury were considering requiring Acquiror and Seller to report their respective allocations on separate copies of Form 8594. 66 Fed. Reg. 9,925 at 9,928 (Feb. 13, 2001).

Instead, IRS developed a separate form for this purpose. Form 8883, Asset Allocation Statement Under Section 338 (Rev. Dec. 2008). In a section 338(h)(10) situation, this form is filed with the returns of Old T and New T. Separate forms are filed, and they need not be conformed. The instructions state that this form allows the parties to make a section 338(h)(10) election on a timely basis, even if the allocation of purchase price among the assets has not yet been determined. As in a section 1060 asset purchase (*see* part I.F.1., above), the parties may not be able to file agreeing Forms 8883, because of differing tax treatment of contingent purchase price and assumption of contingent liabilities, and because of their respective transaction costs. The new form provides for changes in allocation. Supplemental statements must be filed if the allocations change.

b. Section 336(e) Election

The preamble to the regulations under section 336(e) describes the reporting requirements for section 336(e) elections:

> The IRS intends to modify Form 8883, which is currently entitled "Asset Allocation Statement Under Section 338," or create a new form, to include an election under section 336(e). However, until Form 8883 is modified or a new form is created, old target and new target should file Form 8883 to report the results of the deemed asset disposition, making appropriate adjustments as necessary to account for a section 336(e) election.

TD 9619.

3. Other Administrative Requirements

Generally, for purposes other than computing "deemed sale tax consequences" by Old T (*see* part II.B.4.c., above), and asset basis and depreciation by New T, Old T and New T are treated as the same corporation. Examples 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 (including several liability for all income tax owed by a Seller consolidated group under Reg. § 1.1502-6). Reg. §§ 1.338-1(b)(2), (b)(3) and 1.338(h)(10)-1(d)(2).

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

This part discusses the prior section 338 regulations, which applied to transactions that took place before the adoption of the temporary regulations. Transactions after January 5, 2000, are subject to temporary regulations. *See* part II.A., above. Transactions after March 16, 2001, are subject to the current regulations, discussed in part II., above.

Most important, the prior section 338 regulations allowed open transaction treatment to Old T as well as requiring it for New T. This rule generally made a deemed asset sale under section 338(h)(10) more attractive than an actual asset sale, because, in the section 338(h)(10) stock sale, Old T could wait and *see* how the contingency would be resolved while recovering all of its asset basis immediately.

Sellers seeking open transaction treatment under the prior regulations might have been tempted to restructure an asset sale by dropping the assets into a newly-created subsidiary and selling the subsidiary's stock with a section 338(h)(10) election. Using a newly-created subsidiary in a section 338(h)(10) transaction, however, was problematic. For the asset drop to be tax free under section 351, sellers had to retain "control" of Target "immediately after the exchange" by not, for example, entering into a binding commitment or other prearranged integrated plan to sell the Target stock to Acquiror at the time the assets are transferred. Rev. Rul. 70-140, 1970-1 CB 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

The installment method was not available with respect to the deemed asset sale. Upon a section 338(h)(10) election, Old T was deemed to have sold its assets at fair market value to New T and liquidated into its shareholder or shareholders. New T was treated as the purchaser of the assets for all tax purposes. Therefore, Acquiror's installment obligation would not be an obligation of the deemed purchaser of the assets (New T), and so the sale would not qualify. Reg. § 15a.453-1(b)(3)(i) ("payment" under installment method includes receipt of evidence of indebtedness of person other than Acquiror).

2. Amount Realized at Closing

In contrast to an actual asset sale, in a deemed asset sale Old T could adopt a wait-and-see approach as to the contingency to which future payments of purchase price were tied. The open transaction method, ignoring the contingency until it became "fixed and determinable" and treating the purchase price as limited to the cash and fixed obligations paid and the fixed liabilities assumed, seemed to be mandated. Old Reg. § 1.338(b)-3T(c). Old T enjoyed up-front basis recovery on the assets deemed sold without having a portion allocated to the value of its contingent right to future payments. This method aligned, or "linked," the tax consequences of the sale to Old T and New T. It also conformed the character of the contingent payments deemed made to Old T to the character of other sale proceeds (generally capital gain, apart from the interest element).

3. Amount Realized Upon Receipt

When additional contingent purchase price was paid, the principal amount, discounted from the date of sale, was includible as additional sale proceeds, and the balance was includible as interest at the AFR or at a higher agreed-upon rate. Old Reg. § 1.338(b)-1(b) and 1.338(b)-1(c)(2).

4. Allocation of Amounts Realized Among Assets Deemed Sold

Old T's amount realized was the fixed portion of the purchase price, allocated among all assets, tangible and intangible, under section 1060, under the five-class system then in effect. The amount realized was considered paid first 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). Old Reg. §§ 1.338(b)-2T(b), 1.1060-1T(d). These were the only asset classes under the prior section 338 regulations.

5. Post-Closing Adjustments

The prior regulations provided for adjustments to ADSP and AGUB and adjustments to the allocation of purchase price among asset classes for specified events. There were two separate but similar regimes—one for events (referred to as "adjustment events") occurring after Closing but before the end of New T's first taxable year and the other for events occurring later. The events that triggered adjustments were changes in the status of liabilities from contingent to fixed, reductions in amounts paid by Acquiror to Seller (*e.g.*, returns of purchase price) and reductions in the amount of Old T liabilities. If the adjustment event occurred before the end of New T's first taxable year, the adjustment was effective as of the beginning of the day after Closing. Otherwise, the adjustment was effective when the event occurred, "under general principles of tax law." Old Reg. §§ 1.338(b)-1(b), 1-338(b)-1(c)(2), 1.338(b)-3T(a)(1), 1.338(b)-

3T(f)(2). Note that there was no provision to adjust allocation of purchase price to take into account information regarding the fair market value of assets purchased coming to Acquiror's or Seller's attention after Closing.

6. Recovery of Asset Basis

Old T could recover up-front its basis in the assets as of the date of the deemed sale of assets. Old T still could not recognize a loss on the sale, however, until the contingent payments were received or fixed.

7. Character of Amounts Realized – Actual and Imputed Interest

A right to contingent purchase price payments was treated as a separate contingent debt obligation from New T to Old T. Under the open transaction method, Old T still determined 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 was made when the payment was received or fixed, and the principal component was fully includible in Old T's amount realized in the year the amount was paid or the contingency became fixed, and the balance was interest. Because Old T was deemed to liquidate these amounts were taxed to Seller, Old T's shareholder.

B. Treatment of New T

From New T's perspective, a deemed asset purchase involving a contingent purchase price had open transaction treatment, as in an actual asset sale described in part I.D., above. New T generally received no basis for the contingent payments until they were paid. This rule has not changed in the current regulations.

1. Allocation of Contingent Purchase Price Among Assets Purchased

The same rule applied to section 338(h)(10) stock sales as to actual asset sales. *See* part I.D., above. But, under the prior section 338 regulations there were only five asset classes. *See* part II*.A.4., above.

2. Timing of Adjustments to New T's Asset Basis

The same rule applied to section 338(h)(10) stock sales as to actual asset sales. *See* part I.D., above.

a. Upward Basis Adjustments.

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

b. Recovery Methods and Periods – Tangible Assets.

New T allocated each payment, among the purchased assets, in section 1060 order. New T adjusted its basis in depreciable property and took depreciation deductions proportionately over the remaining life of the assets. If an asset entitled to a basis adjustment had been sold or disposed of, New T was entitled to a loss deduction. Old Reg. §§ 1.338(b)-3T(c), 1.338(h)(10)-1(e)(5). There were mechanisms to adjust New T's basis, as described in part II*.A.5., above.

III. Escrows and Other Returns of Purchase Price

An escrow may be used to secure either contingent purchase price payments to be made by Acquiror to Seller or indemnities by Seller to Acquiror for breach of Seller's covenants, representations or warranties, or for undisclosed liabilities. The tax issues raised by these escrows include the following:

- Are the amounts placed in escrow treated as part of Seller's amount realized at Closing (in whole or in part)?
- To which party is the income on the escrowed funds taxed, as earned and as distributed?
- How are adjustments made once the recipient of the escrowed funds is determined and the funds are paid?

Proposed regulations under section 468B(g), published in January 1999, would determine how the income on escrowed funds is taxed but not the other issues. These are left to case law, which supports rules that are not consistent with those in the proposed regulations. If the proposed regulations are adopted, there will be significant inconsistencies in the treatment of the escrows.

A. Whose Property Is the Escrow?

Depending on the nature of the contingency, funds placed in escrow may belong to Seller, Target or Acquiror for tax purposes.

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

a. Escrow to Protect Acquiror Against Undisclosed Liability or Other Breach of Contract

An escrow may protect Acquiror against undisclosed or unascertainable liabilities of the business or breaches by Seller of covenants, warranties or representations in the sale agreement. IRS takes the view that Seller is deemed to receive the escrowed funds unless its rights to the funds are subject to substantial restrictions. Otherwise, the funds are treated as continuing to belong to Acquiror. Rev. Rul. 79-91, 1979-1 CB 179; Rev. Rul. 77-294, 1977-2 CB 1973; PLR 200521007 (Feb. 25, 2005). The case law is not so clear. *Compare Anderson v. Commissioner*, 20 T.C.M. 697 (1961) (Seller recognizes no income when Acquiror places funds in escrow against possible breach of warranty as to undisclosed corporate liabilities), with *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937) (Acquiror stock received by Seller in taxable exchange and transferred by Seller to escrow to secure Seller's obligations; stock would be sold and applied to compensate for Seller's breach; held, stock taxable as sale proceeds to Seller despite escrow).

b. Seller's Liability

If the escrowed funds relate to a liability of Seller that is not related to the business that was sold, they benefit only Seller and so are taxed as part of the sale proceeds at Closing. *Estate of Steckel v. Commissioner*, 253 F.2d 267 (6th Cir. 1958), *aff'g per curiam*, 26 T.C. 600 (1956). This is not the usual acquisition escrow.

c. Other Escrows Treated as Belonging to Seller

Even if the escrow is subject to substantial restrictions, Seller still may be taxed on the escrowed funds if it has control over them. For example, in *Chaplin v. Commissioner*, 136 F.2d 298 (9th Cir. 1943), Charlie Chaplin received United Artists stock for his future delivery of five photoplays. The stock was placed in escrow pending performance, but, while the stock was in escrow, Chaplin had the rights to vote the stock and to receive dividends. The court held that the stock was taxable to Chaplin despite the escrow. Similarly, in GCM 37073 (March 31, 1977), Chief Counsel concluded that an accrual method taxpayer was taxed on funds transferred to a custodian pending performance under a contract, because the taxpayer had investment power over the escrowed funds.

d. Conclusion

In most cases, escrowed funds are treated as belonging to Acquiror. Only in abusive situations (*e.g.*, where Seller has "constructive receipt" or "economic benefit" of the funds) are funds escrowed by Acquiror treated as transferred to Seller. Nevertheless, the parties should reach agreement on this point, document it and report consistently, so that the agreed-upon party indemnifies the other for the tax if IRS disagrees.

2. Income on Escrowed Funds

Rev. Rul. 71-119, 1971-1 CB 163, *revoked*, Rev. Rul. 92-51, 1992-2 CB 102, created the possibility of "homeless" income on escrows, *i.e.*, income on which no one pays tax as long as the escrow lasts. After enactment of section 468B(g) in 1986, however, escrows could no longer generate 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 several ways. Seller could be the grantor of a grantor trust (escrowed funds treated as though paid to Seller and then placed in escrow), or Acquiror could be the grantor (escrow funds treated as contingent purchase price not yet paid, as discussed in part I., above). Or, the escrow could be a separate taxpayer. In the absence of regulations under section 468B(g), Seller and Acquiror may structure an escrow arrangement by choosing which of them is treated as the grantor. In January 1999, regulations were proposed to require that, for purposes of taxing escrow income, escrowed purchase price is treated as continuing to belong to Acquiror (the provider of the funds) until the rights to the funds are fully established. Prop. Reg. § 1.468B-8 (Jan. 29, 1999). *See* part III.B.3., below.

3. Disputed Ownership Funds

The proposed regulations contained separate rules for "disputed ownership funds," which are escrows and similar funds under court jurisdiction pending resolution of a dispute. Prop. Reg. § 1.468B-9. These proposed regulations were adopted as final regulations with minor changes in 2006. TD 9249, 71 Fed. Reg. 6197 (Feb. 7, 2006). The income of such a fund is taxed to the fund as a separate entity, generally a qualified settlement fund ("QSF"), under Reg. § 1.468B-1. The 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 Acquiror so elects, Acquiror will continue to be taxed on escrow income. The preamble to the proposed regulations requests comments as to transitions of funds from contingent at-closing escrow to "disputed ownership fund" status.

4. Case Study – E&Y-Cap Gemini Transaction

a. Transaction

In 2000, Ernst & Young sold its consulting business to Cap Gemini, S.A., a French public company. As a part of the sale, the E&Y consulting partners exchanged their E&Y partnership interests for Cap Gemini stock and became Cap Gemini employees. Cap Gemini placed the stock in escrow, to be released periodically over five years. Some or all of a consultant's stock would be forfeited if, during the escrow period, he or she left Cap Gemini's employ voluntarily, or if his or her employment were terminated for cause or for "poor performance." In the meantime, he or she had the rights to vote the stock and receive dividends but could not sell it. Presumably, he or she could have hedged the investment, *e.g.*, by a short sale of Cap Gemini stock. If a consultant did this, however, and the escrowed stock were forfeited, he or she would have been exposed to a short position.

b. Tax Treatment Agreed by the Parties and Expected Tax Benefits

The exchange did not qualify for nonrecognition and was a taxable exchange. The value of the Cap Gemini stock received by each consultant was greater than his or her basis in the surrendered E&Y partnership interest. In the contract, the parties agreed that, for tax purposes, the escrowed stock would be treated as paid to the consultants at Closing, and that the value of the escrowed stock would be determined at a small designated discount from its traded value on the Closing date.

If this tax treatment prevailed, both parties expected to benefit:

- Cap Gemini would be entitled to include the agreed value of the stock in its tax basis for the consulting business assets and so would be entitled to begin taking section 197 amortization deductions with respect to this basis immediately after Closing.
- Each consultant would be taxed immediately on his or her gain in the exchange (value of stock less basis in E&Y partnership interest surrendered), but all the gain would be taxed as capital gain, and tax on future appreciation of the Cap Gemini stock would be deferred indefinitely and then taxed, if at all, as capital gain.

c. Later Events and Tax Consequences

Contrary to expectation, the value of the Cap Gemini stock declined steeply after the Closing. This surprise did not affect Cap Gemini's amortization deductions. For the selling consultants, however, the decline in the value of the stock disrupted the tax planning. By the time the stock was released from escrow, they had been taxed on gain that had disappeared. They could have sold the stock at a capital loss at that time, but the loss could not have been carried back to shelter gain on the earlier exchange. The loss could have been used only to shelter unrelated capital gains in later years. *See* part I.C.2.f.(2), above.

d. The Consultants' Refund Claims

In light of this adverse development, some of the consultants abandoned the tax planning embodied in the contract. Instead, they claimed refunds based on an open transaction method: Gain recognized, not at Closing but later, when the stock was released from escrow, and measured by the reduced value of the stock at that time. IRS denied the claims, or in some cases first allowed the claims and later sued to recover the refunds.

e. Court Decisions

Decisions on this matter have been issued by seven lower courts, and appeal decisions have been issued in three circuits. All of the decisions have been in favor of the Government. Some courts have held that the consultants were bound by the contract regarding tax treatment. Others have considered the merits and held that the agreed tax treatment was correct.

(1) Decisions Based on the Contract

In the two earliest decisions, lower courts ruled in favor of the Government, based on the consultants being bound by contract to have the gain taxed at Closing. *United States v. Culp*, 99 AFTR 2d 2007-618 (M.D. Tenn. 2006); *United States v. Berry*, 2008-2 USTC ¶ 50590 (D.N.H. 2008). Both of these courts applied the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). *Danielson* involved a stock-for cash-acquisition with a covenant not to compete. In the contract, amounts were allocated to the stock and to the covenant. At the time Sellers signed the contract, however, they did not realize that the payment they received for the covenant would be taxed as ordinary income. Contrary to the agreement, Sellers reported all the amounts received as amount realized on the sale of the stock and all their gain as capital gain. Concerned with an apparent whipsaw, IRS issued a deficiency notice based on the treatment in the contract. The Tax Court held for Sellers, based on its finding that the prices in the contract had not been separately bargained-for and were arbitrary. The Third Circuit reversed, holding that, unless there is proof of fraud, misrepresentation, duress or other reason to void the contract, the parties are bound by the form in the contract, and that only IRS may challenge that form. The court reasoned that to allow a party to attack a contract "would be in effect to grant, at the insistence of a party, a unilateral reformation of the contract with a resulting unjust enrichment." In addition, the court was concerned that allowing such challenges would burden tax administration and increase litigation.

The *Culp* and *Berry* courts followed *Danielson*, focused on the contract and did not consider underlying merits of the tax law. The consultants tried to overcome the contract with an argument that they had signed the contract under duress, but the courts held that any duress was not enough to overcome the contractual obligations. The fact that the consultants changed tax position because of post-Closing developments and based on hindsight seems to have been important.

Later, one court of appeals decided the issue for the Government, again relying on the consultants' contractual obligations but using the Fourth Circuit standard, which differs somewhat from the *Danielson* standard. *United States v. Bergbauer*, 602 F.3d 569 (4th Cir. 2010), *aff'g* 102 AFTR 2d 2008-5932 (D. Md. 2008).

(2) Decisions Based on the Merits

The first court of appeals to rule on the E&Y-Cap Gemini transaction was the Seventh Circuit. *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 2009), *aff'g* 101 AFTR 2d 2008-588 (N.D. Ill. 2008). As in *Culp* and *Berry*, the District Court in *Fletcher* had relied on *Danielson*. The Seventh Circuit affirmed but based its decision on a different theory—described as the "constructive receipt" doctrine applicable to cash method taxpayers. Thereafter, the Eleventh Circuit and two lower courts adopted the same approach. *United States v. Fort*, 107 AFTR 2d 2011-1873 (11th Cir. 2011), *aff'g* 105 AFTR 2d 2010-2559 (D. Ga. 2008); *United States v. Nackel*, 686 F. Supp. 2d 1008 (C.D. Cal. 2009); *Hartman v. United States*, 107 AFTR 2d 2011-2244 (Ct. Fed. Cl. May 13, 2011).

If money is set aside for the benefit of a cash method taxpayer, and the taxpayer has a right to immediate possession, he or she is said to be in "constructive receipt" of the money and is subject to tax without deferral. If control or receipt of the set-aside money is subject to substantial limitations or restrictions, however, there is no immediate tax under the constructive receipt doctrine. Treas. Reg. § 1.451-2(a). In *Fletcher*, *Fort*, *Nackel* and *Hartman*, the courts held that the consultants had constructively received the Cap Gemini stock at Closing and were taxed at that time.

The consultants had no right to possession of the stock until the escrow expired five years after Closing. During that time, they had to perform services for Cap Gemini as employees (or more precisely, not leave Cap Gemini voluntarily and not be terminated for cause or poor performance) before the stock would be released from the escrow. In the meantime, however, they could vote the stock and receive dividends. They also had the burdens and benefits of fluctuations in the value of the stock. The courts regarded these facts as dispositive, found constructive receipt and imposed immediate tax on the consultants.

There is a doctrine similar to constructive receipt, known to as the "economic benefit" doctrine. Under this doctrine, a cash method taxpayer is taxed on money or property set aside for his or her benefit, without condition and not subject to the claims of the payor's creditors, even if the recipient has no immediate right to possession. This doctrine and the distinction between it and constructive receipt are explained in *Sproull v. Commissioner*, 16 TC 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

There is no immediate tax under either doctrine if the taxpayer's right to the money or property is "subject to substantial limitations or restrictions." Treas. Reg. § 1.451-2(a) (dealing specifically with constructive receipt). Thus, the *Fletcher*, *Fort*, *Nackel* and *Hartman* courts considered whether the consultants' right to receive the stock was subject to substantial limitations or restrictions.

The courts found no such limitations or restrictions, primarily because the risk of termination of the consultants' employment for "cause" or "poor performance" was largely within their own control. This conclusion is questionable for two reasons:

- A consultant would forfeit his or her stock if Cap Gemini terminated his or her employment for "cause" or "poor performance." Even if these criteria are objective (as the courts found), an employee's performance depends on his or her ability to work within the employer's environment, not necessarily a matter within his or her control.
- More important, a condition being within the taxpayer's control should not cause tax to be due under either constructive receipt or economic performance analysis. In the E&Y-Cap Gemini transaction, the consultant would have to give up his or her right to change jobs in order to receive his or her stock. IRS has ruled that a requirement to give up something of value to receive property is a limitation or condition that prevents constructive receipt:

  > The courts and the Internal Revenue Service have recognized that a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to make inapplicable the doctrine of constructive receipt.

  Rev. Rul. 80-300, 1980-2 CB 165 (no constructive receipt on stock appreciation right when stock appreciates, because exercise requires forfeiture of right to benefit from further appreciation without capital investment), amplified by Rev. Rul. 82-121, 1982-1 CB 79 (same for stock options).

There is yet another similar doctrine sometimes invoked to accelerate tax liability on property before the taxpayer actually receives it: the "dominion and control" doctrine. This doctrine has been applied where the taxpayer has the power to substitute investments held by an escrow.

Chaplin v. Commissioner, 136 F.2d 298 (9th Cir. 1943); GCM 37073 (March 31, 1977), described in part III.A.2.c., above. In some cases, the dominion and control doctrine is applied even if there is no right of substitution (which the consultants did not have), where the taxpayer has the right to receive income on the escrowed property and bears the risk of increase or decrease in the value of the property. *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937). In *Bonham*, the taxpayer exchanged stock of a corporation for stock in another corporation in a taxable exchange. He agreed to allow the purchaser of his stock to hold some of the stock he was to receive, to secure covenants he made in connection with the sale. If his covenants were not met, the stock could be sold at its then-value used to reimburse the buyer for its loss. The court held that the seller had dominion and control over this stock, and that he was taxed on receipt of this stock at the time of Closing. This dominion and control doctrine seems closer to the consultants' situation than either constructive receipt or economic benefit. Even this doctrine, however, would be stretched to include their situation, Bonham's stock would be sold at its then-value to pay damages for breach of covenants. By contrast, the consultants would forfeit their Cap Gemini stock if they failed the conditions of continued employment, regardless of the value of the stock or the amount of any damage to Cap Gemini from such a failure.

As a final observation, use of constructive receipt, economic benefit or dominion and control analysis, in the context of a sale or exchange of property, as in *Fletcher*, *Fort*, *Nackel* and *Hartman*, is reminiscent of the "cash equivalent" test once used to defer tax on sales by cash method taxpayers. This test no longer applies, because it was preempted by enactment of section 453 that made the installment method available. *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975). *See* part I.C.3.c., above.

f. Alternative Approaches

(1) General

From the viewpoint of the consultants, the E&Y-Cap Gemini transaction was a hybrid, composed of two overlapping elements:

- A taxable exchange of property (E&Y partnership interests for Cap Gemini stock) at a gain.
- An arrangement under which the consultants would forfeit their stock unless they provided services as employees of Cap Gemini for five years (more precisely, by not leaving voluntarily or being terminated for cause or poor performance).

(2) Section 83

If the consultants had received their Cap Gemini stock only "in connection with the performance of services" (not in exchange for their partnership interests), the arrangement would have been subject to section 83. Because the consultants were conditionally entitled to stock (property) and not cash, section 83 would prevail.

Under section 83, tax to the consultants would have been deferred until the stock was no longer subject to a substantial risk of forfeiture, and the stock would have been valued and taxed at that time. (For purposes of this discussion, the risk of forfeiture is assumed to be substantial despite the skepticism of some of the courts.) At that time, this amount would be treated as compensation paid by Cap Gemini to the consultants—taxed as ordinary income to the consultants and either currently deductible or capitalized and amortized by Cap Gemini under general accounting rules.

Each of the consultants could have changed this tax treatment by filing an irrevocable election under section 83(b) within 30 days after the Closing, with the following tax consequences:

- The full value of the stock at Closing (with no discount for risk of forfeiture) would have been taxed to the consultants as ordinary income.
- The same amounts would be treated as compensation paid by Cap Gemini to the consultants at Closing, again either currently deductible or capitalized and amortized.
- If the restriction lapsed after five years, and the stock was distributed by the escrow to the consultant, there would have been no further tax consequences to either party.
- If the consultant forfeited the stock, the forfeiture would have been treated as a sale of the stock, but basis would not have included the compensation income.

Economic benefit and constructive receipt analysis would not be relevant, because section 83 preempts both doctrines.

(3) Closed or Open Transaction Treatment of Taxable Exchange

By contrast, if the transaction had been only a taxable exchange with contingent purchase price (again assuming the contingency was substantial), it appears the consultants could have used the installment method to defer tax on delayed receipt of the stock. Alternatively, they could have elected out of the installment method and recognized gain at Closing based on the value of Cap Gemini's promise to issue stock to them if the conditions were met, *i.e.*, the closed transaction method. If the promise could not be valued, they could have used the open transaction method.

Again, it is unlikely that economic benefit or constructive receipt analysis would have been relevant. The consultants actually received a conditional promise from Cap Gemini to issue stock to them. In a sale situation, this promise alone is a taxable amount realized, even to a cash method taxpayer. *See* generally parts I.A.-C., above.

(4) Reconciling Section 83 and Sale Treatment in a Hybrid Transaction

Thus, the two competing tax regimes (section 83 and exchange) are not consistent. It is not obvious how to reconcile the inconsistencies in a hybrid transaction like the E&Y-Cap Gemini transaction. The analysis by the courts in *Fletcher*, *Fort*, *Nackel* and *Hartman* is not, however, consistent with either of these regimes.

Apart from its litigating positions in the E&Y-Cap Gemini cases, IRS has made one attempt to reconcile these tax regimes in a hybrid transaction. Rev. Rul. 2007-49, 2007-2 CB 237, Situation 3. Despite its having been issued while the E&Y-Cap Gemini cases were pending, none of the courts deciding these cases cites Rev. Rul. 2007-49.

In Rev. Rul. 2007-49, Individual A and others own all the stock of X Corp with no restrictions. A provides services to X, and the other X shareholders are passive investors. In a taxable exchange, Y Corp acquires all the X stock for Y stock and cash. The X shareholders other than A receive cash and Y stock without restriction. A receives only Y stock and becomes an employee of Y. A's Y stock is subject to restrictions that come into play if A's employment terminates before a specified date. (*See* part VIII.G.2., below, for discussion of hybrid tax-free reorganizations under Rev. Rul. 2007-49.)

IRS ruled that A is treated as exchanging X stock for the full value of the Y stock received at Closing, with no discount for the restrictions. A's gain or loss is recognized. A is also treated as buying Y stock for that value.

- If A elects under section 83(b), A is not taxed on any income at Closing, because A paid full value for the Y stock, and A is also not taxed when the restrictions lapse.
- If A does not so elect, A is still not taxed on any income at Closing, now because of the risk of forfeiture. A has compensation income on any appreciation in the Y stock from the time of Closing until the restrictions lapse.

An alternative view (using the facts of Rev. Rul. 2007-49) is that A sells his X stock for contingent consideration, discounted to reflect the risk of forfeiture, and that any additional value received would be taxed to A when the contingency becomes fixed. As discussed in parts I.C.2.f. and g., above, the additional value is likely to be taxed as ordinary income, but capital gain is possible. If the stock with the risk of forfeiture could not be valued, the open transaction method would be available. If this regime is preferable to that of Rev. Rul. 2007-49, query whether the parties may "plan into" it by postponing the actual receipt of the Y stock until the restrictions were intended to lapse (three years after Closing in Rev. Rul. 2007-49).

Rev. Rul. 2007-49 does not discuss the precise situation involved in the E&Y-Cap Gemini transaction: A exchanges his or her X stock for Y stock of equal value (with no section 83(b) election), and the Y stock declines in value before it becomes vested in A's hands. In this case, A will be deemed to purchase the Y stock for a price higher than its actual value when it becomes vested. Thus, there is no compensation income to A. Query whether Cap Gemni would be taxed on the excess.

Since there is no compensation income, is the stock transferred to A "in connection with the performance of services"? The court in *Bergbauer* says no: "The CGE&Y for Cap Gemini equity interest exchange was clearly not related to the performance of services and the Bergbauers do not contend to the contrary." If not, section 83 does not apply. The court's conclusion seems at odds with the analysis of hybrid transactions in Rev. Rul. 2007-49 and with the broad interpretation of "in connection with the performance of services" applied elsewhere. *Alves v. Commissioner*, 79 T.C. 864 (1982) (property transferred "in connection with the performance of services" even if transferred for full value); Treas. Reg. § 1.83-2(a) (section 83(b) election available even if property is purchased for full value).

If section 83 does apply, and again using the facts of Rev. Rul. 2007-49, it appears that, if the value of the Y stock at the time of vesting is less than the amount A paid for the Y stock (*i.e.*, the value of the X stock A surrendered), the amount paid by A for the Y stock would be A's basis in the Y stock when vested.

g. Planning Considerations for Escrow Transactions

(1) Contractual Provisions on Tax Treatment

The E&Y-Cap Gemini cases (especially *Culp*, *Berry*, *Bergbauer* and the district court decision in *Fletcher*) illustrate the dangers of post-transaction tax planning. Advisers should consider all the possible consequences of including agreed tax treatment in a contract, bearing in mind that, under *Danielson*, the taxpayer may be bound by the contract vis-à-vis IRS, as well as the other parties, whereas IRS is not bound at all. Some courts apply these rules only within limited scope. Nevertheless, an attempt to apply tax treatment inconsistent with a contract—especially as an afterthought in light of unexpected post-transaction developments—creates a peculiarly unsympathetic situation, even if the afterthought tax treatment is technically superior on the merits to the contracted-for treatment. *See, e.g., Insilco Corp. v. United States*, 53 F.3d 95 (5th Cir. 1995) (post-return filing attempt to apply step transaction doctrine to re-characterize a section 338 stock sale as transaction subject to sections 304 and 351 rejected).

(2) Rights in Escrowed Property

If sale proceeds are placed into escrow, Seller should weigh the advantages of rights in the escrowed property, (such as rights to vote or receive dividends on escrowed stock or receive other income on escrowed property during the escrow term or the unilateral right to substitute other property for the escrowed property) against the tax risk. The existence of such rights could cause the escrowed property to be treated as transferred to Seller and as taxed currently, even if the installment method is used.

(3) Contingencies Relating to Escrowed Property

If Seller's right to receive the property from the escrow is subject to contingencies relating to future performance of services by Seller, the outcome described in Rev. Rul. 2007-49 is likely. In such a case, the planning trade-off between immediate capital gain and deferred ordinary income should be analyzed, and a section 83(b) election should be considered.

Other types of contingencies should not invoke section 83. Instead, these contingencies should be taken into account under the installment method, the closed transaction method or the open transaction method, as applicable.

No guidance exists for situations in which there are contingencies relating to both future services and other matters (*e.g.*, earn-outs).

B. Escrow as Acquiror's Property

1. Treatment at Closing to Seller

If the escrowed funds continue to belong to Acquiror, and if Seller reports the sale on the installment method, deferral of the escrowed amount is permitted until the escrow is resolved. If the installment method does not apply, or if Seller elects out, Seller realizes the fair market value of its contingent right to the escrowed funds in the year of Closing under the closed transaction method. In "rare and extraordinary cases", the open transaction method may be available. Reg. § 1.1001-1(g)(2)(ii). In other words, the escrow is a kind of contingent purchase price. *See* parts I.B. and I.C., above. If the escrow fund assumes contingent liabilities, Seller may (or may not) also have to include in its amount realized at Closing the fair market value of the assumption itself. *See* part II.B.2.d., above.

2. Treatment at Closing to Acquiror

Since the escrow is treated as contingent purchase price, Acquiror is not entitled to deduct the payment to the escrow or take it into account in its basis at Closing, because the amount of the payment is not "fixed and determinable," and there has been no "economic performance." That is, Acquiror generally may not include the escrowed funds in its basis until the escrowed funds are paid to Seller. TD 9140, 69 Fed. Reg. 43,302 (July 20, 2004) (payment to escrow satisfies economic performance requirement only if payment discharges payor's obligation).

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

a. "Contingent At-Closing Escrow" Defined

Under proposed regulations, 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 (*see* part VII., below) or a deferred section 1031 exchange. REG-209619-03, 1999-1 CB 689. Section 351 exchanges and section 355 corporate separations are not mentioned. The escrow awaits resolution of contingencies that will determine whether Acquiror or Seller is entitled to the escrowed funds. Until all issues that could determine receipt of the escrow are resolved, the income on the escrow would continue to be taxed to Acquiror, even if escrowed funds are distributed to Seller. To fine tune the application of this rule (if it becomes effective, or if the parties agree to follow this approach), consider a separate escrow fund for each contingency, so that each determination can affect its own separate fund.

b. Scope of Proposed Regulations

The treatment of income earned on escrows is the only issue resolved in the proposed regulations. The proposed regulations do not determine ownership of the escrowed funds for other purposes, such as the timing of amount realized on the sale, asset basis or the character of the distribution as interest or principal. Prop. Reg. § 1.468B-8(d). Nor do the proposed regulations treat appreciated property in the escrow as sold to Seller on a "determination date," even if the escrowed property is distributed to Seller.

c. Treatment of Contingent At-Closing Escrow – "Determination Date"

Prop. Reg. § 1.468B-8(c) provides that, in a contingent at-closing escrow, income on the escrowed funds is always taxed to Acquiror until the "determination date," *i.e.*, the date the last bona fide contingency involving payment of the escrowed funds is resolved. It does not matter whether Acquiror or Seller is treated as the owner of the escrowed funds for other purposes. After the "determination date," income is taxed to the owner of the funds at that time.

d. Status of Proposed Regulations

In 2006, portions of the proposed regulations were adopted as final regulations. The preamble to the Treasury Decision states, however, that the proposed regulations on contingent at-closing escrows "requires further consideration" and so would be adopted separately.

4. Payment of Escrowed Funds to Seller

Each payment to Seller from the escrow is discounted from the date of sale subject to the imputed interest rules of sections 483 and 1274 (or a higher stated rate if the parties have so agreed). The interest portion is taxable to Seller and deductible to Acquiror. Under the tax accounting rules, the principal portion of the escrowed funds does not, entitle Acquiror to include the escrowed funds in its basis in the purchased assets until it is determined that the escrowed funds are to be paid to Seller.

5. Return of Escrowed Funds to Acquiror

The return of escrowed funds to Acquiror 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 no more than a return to Acquiror of its own funds.

6. Use of Escrowed Funds to Pay Seller Liabilities

Escrowed funds are commonly used to pay Seller's contingent or other undisclosed liabilities. If these liabilities become fixed, and escrowed funds are used to pay them, the amounts paid should be treated like payments of contingent liabilities assumed by Acquiror. The amount paid from escrow to satisfy the contingent liability should be added to Seller's amount realized on the sale (except to the extent already included at Closing—*see* part III.B.1., above). Seller should be entitled to an offsetting deduction for the amount paid, if the liability is a deductible item. *See* parts IV.D.2.a. and IV.D.3., below. The amount should be added to Acquiror's basis in the acquired assets. *See* parts IV.D.2.c. and IV.D.3.b., below.

C. Escrow as Seller's Property

If the escrowed funds are treated as paid to Seller and transferred by Seller to the escrow, the tax consequences do not depend on the contingent purchase price rules.

1. Treatment at Closing to Seller

Section 1001(b) applies, because the escrowed funds are part of the sale proceeds. *See* parts I.C.2 and II.B.2.a. and b., above. That is, the full amount of the escrowed funds is added to Seller's amount realized. There is no imputed interest Seller may not treat the escrow as an installment sale.

2. Treatment at Closing to Acquiror

There is no authority as to whether Acquiror should be allowed to include the escrowed payments in its asset basis. Treating escrowed funds like contingent purchase price generally would prevent inclusion in basis until the escrow closes. *See* parts I.E. and II.C., above. But treating the funds as though paid to Seller and then set aside in escrow, subject to possible return to Acquiror, would allow Acquiror to include the funds in its basis for the purchased assets.

3. Income Earned on Escrowed Funds

a. Investment Treatment

Under Prop. Reg. § 1.468B-8(c), discussed in part III.B.3., above, even if the escrow is Seller's property for tax purposes generally, the income earned on the escrowed funds still would be taxable to Acquiror until the "determination date." Thus, Seller could be taxed in full on the escrowed funds at Closing, while Acquiror is taxed on the income from those funds—clearly inconsistent treatment. If this rule is followed, the parties would have to restore economic reality by allocation tax agreement especially, if the escrowed funds are ultimately paid to Seller.

b. Example

Suppose an escrow of part of the purchase price paid for a business is treated as belonging to Seller at Closing. That is, at Closing the funds in escrow are included in Seller's amount realized on the sale. The amount realized by Seller and Acquiror's asset basis are computed without regard to the proposed regulations. Suppose further that the income on the escrowed funds is distributed to Seller periodically as earned. Still, under § 1.468B-8, the income would be taxed to Acquiror. Does the distribution of the income to Seller count as additional purchase price, taxed again to Seller? Or, does the limited scope provision in Prop. Reg. § 1.468B-8(d) mean that this income and its distribution are simply ignored for purposes of amount realized and basis? If so, Acquiror 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 reconsider their approach to this income.

c. Avoiding the Problem

To avoid this complication, Acquiror and Seller should consider not escrowing funds that belong to Seller for other purposes. For example, the parties could agree that the escrowed funds belong to Acquiror until the determination date. Nevertheless, Seller probably would have to treat its contingent right to receive the escrowed funds as amount realized at Closing, under the "closed transaction" method. *See* part I.C.2., above.

4. Payment of Escrowed Funds to Seller

There are no consequences to a distribution of escrowed funds to Seller. The escrowed 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 in Seller's income.

5. Escrow as Seller's Property – Treatment on Return to Acquiror

a. Treatment to Seller

(1) Full Amount of Escrow Funds Included in Seller's Amount Realized

If escrowed funds that were included in Seller's amount realized are returned to Acquiror, the case law suggests that the result is a reduction in the price Acquiror paid for the assets. Under principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the treatment to Seller could be a capital loss on the sale. *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo 1977-429 (escrow payment to Acquiror from third party treated as reduction in purchase price when received).

(2) Escrow Secures a Deductible Obligation

A portion of the purchase price may be placed in escrow to secure an obligation retained by Target, and the obligation may be one that, had it been paid by Target before Closing, would have generated a deduction to Target. Examples include liabilities for product warranties, deferred employee compensation and some environmental remediation. In such a situation, Target may deduct payments from the escrow to satisfy the obligation, to the same extent it could have deducted the payment if it had not sold the business. *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943); Rev. Rul. 75-154, 1975-1 CB 186. *See* part IV.G., below.

(3) Fair Market Value of Contingent Price Included in Seller's Amount Realized

If Seller has treated the escrowed funds as contingent purchase price and so included the fair market value of the contingent payment right in amount realized at Closing, the return of the escrowed funds to Acquiror would result in a loss to Seller on the separate contingent payment right.

b. Treatment to Acquiror

If the escrowed funds have been included in Acquiror's basis in the purchased property (*see* part III.C.2., above), a return of the funds to Acquiror would reduce Acquiror's basis (except that any income on the escrowed funds already taxed to Acquiror would be a tax-free return of capital).

6. Escrow as Seller's Property – Treatment on Use of Escrowed Funds to Pay Seller Liabilities

a. Treatment of Seller

If Seller has already included the principal of the escrow in its amount realized on the sale, the use of this principal amount to pay Seller liabilities would not be added to Seller's amount realized again. If the escrow has accumulated income, and this income has been taxed to Acquiror (as would be required by Prop. Reg. § 1.468B-8, discussed in part III.B.3., above), the amount of income so used should be added to Seller's amount realized on the sale. Seller should be entitled to offsetting deductions for the amounts paid (to the extent not already deducted). *See* part III.B.7.a., above, and parts IV.D.2.a. and IV.D.3., below.

b. Treatment of Acquiror

The amount paid should be added to Acquiror's basis in the acquired assets. *See* part III.B.7.b., above, and parts IV.D.2.c. and IV.D.3.b., below.

D. If Escrowed Property Is Stock of Acquiror or Acquiror's Parent in a Taxable Acquisition

1. Escrowed Stock – Taxable Gain to Acquiror

a. Stock of Acquiror

Suppose Acquiror places its own stock in escrow as part of the consideration in a taxable acquisition, and the stock appreciates while in escrow. Regardless of whether the stock is treated as owned by Acquiror or Seller, there should be no taxable gain to Acquiror, under section 1032.

b. Stock of Acquiror's Parent

Suppose Acquiror is a subsidiary, and stock of Acquiror's parent is placed in an escrow. Does Acquiror recognize taxable gain if the escrowed stock appreciates in value and then is released to Seller? *See* Rev. Rul. 74-503, 1974-2 CB 117, *revoked*, Rev. Rul. 2006-2, 2006-1 CB 261.

If Acquiror and its parent file consolidated returns, Acquiror would recognize no gain on its use of parent stock to acquire property, provided a series of tests are met. One of these tests is that the subsidiary must transfer the stock "immediately" and "pursuant to a plan" to an unrelated non-member. Reg. § 1.1502-13(f)(6)(ii). No loss is recognized on common parent stock in any event. Reg. § 1.1502-13(f)(6)(i).

The regulations adopt a similar approach without regard to whether parent and Acquiror file consolidated returns (and even without regard to whether parent and Acquiror are affiliated). Under these regulations, Acquiror would recognize no taxable gain or loss, provided it transfers the stock "immediately." Reg. § 1.1032-3(c)(2). Based on examples in the regulations, "immediately" seems to mean that, in an escrow situation, Acquiror may not be entitled to any reversionary interest in the parent stock. Thus, escrow agreements involving parent stock should provide that any reversion of the parent stock is to the parent, not to Acquiror.

2. Escrowed Stock – Tax on Dividends

a. Stock of Acquiror

Suppose Acquiror places its own stock in escrow in a taxable acquisition. Under Prop. Reg. § 1.468B-8, any dividends paid on the escrowed stock would be considered to belong to Acquiror and so would be tax-free.

b. Stock of Acquiror's Parent

Suppose Acquiror is a subsidiary, and stock of Acquiror'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—probably 100% under section 243(b).

IV. Contingent Liabilities in Taxable Asset Acquisitions

A. Introduction

In asset acquisitions Acquiror may assume Seller's obligations that are contingent in amount, timing, or both. These types of contingent obligations include obligations for retirement, vacation and severance pay and other employee benefits, environmental remediation costs, commercial and tort claims, product warranties, tax deficiencies, etc. The tax consequences depend upon whether the particular item is treated as an assumed liability (capitalized as part of the purchase price) or as Acquiror's own expenditure (possibly deductible). Generally, the tax consequences affect Acquiror more than Seller. Another type of contingent liability can arise if Seller has agreed to provide goods or services in the future, generally to a customer. This situation is easiest to see as a "liability" if Seller has been paid in advance for these goods or services, but prepayment may not be necessary to create a "liability".

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

1. Seller's or Acquiror's Liability – Consequences

a. Seller's Liabilities Assumed

If Acquiror assumes Seller's liabilities, the assumed liabilities are treated as part of the price paid for the assets. Seller treats the assumption (or expenditures to pay the liabilities) as increasing the sale price, resulting in gain, often with offsetting deductions, and Acquiror capitalizes the expenditures in the basis of the purchased assets, instead of deducting them. The "economic performance" requirement of section 461(h) is often critical in determining when (but not if) Seller may deduct the item and when (again, not if) Acquiror may include the item in the basis of the purchased assets.

b. Acquiror's Costs

If an expenditure is considered Acquiror's own cost of operating the acquired business, then it has no impact on Seller, and it is deductible or capitalized by Acquiror under its normal accounting method, as though there had been no acquisition. Again, the "economic performance" test may be critical to timing.

c. Incentives to Seller, Seller and Acquiror

It is generally advantageous to all parties to treat an expenditure by Acquiror as Acquiror's cost of doing business, rather than as an assumption and payment by Acquiror of Seller's liability.

This is especially true if the expenditure would result in an immediate deduction upon payment, as is most common.

d. Capitalization or Deduction by Acquiror

The regulations provide that Acquiror My deduct, instead of capitalizing, certain types of acquisition expenditures. The expenditures receiving this favorable treatment are those incurred to acquire intangible property (including certain transaction costs), if the property has a useful life of no more than 12 months from the time the taxpayer "realizes" the intangible or the end of the taxable year following the year in which the payment is made, whichever is less. Assumed contingent liabilities are not mentioned. Unfortunately, however, the regulations make clear that this 12-month rule does not apply to expenditures incurred to acquire a trade or business. Reg. §§ 1-263(a)-4(f), 1-263(a)-5(a). Reg. § 1.162-3T(c)(1)(ii) is a similar rule for acquisitions of tangible property.

2. Authorities and Factors

How can we tell the difference between Acquiror's own costs and Seller's liabilities assumed by Acquiror? There are numerous authorities, especially in the compensation area, but it still may be difficult to tell. The following factors are relevant in determining whether an expenditure by Acquiror results from a liability assumed from Seller:

a. Pre-Sale Operations

Does the expenditure arise from Seller'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), reh'g denied 416 U.S. 952 (1974). Acquiror bought Target stock, and Target was liquidated under old section 334(b)(2) (purchase of Target stock and complete liquidation of Target treated as asset purchase on Acquiror side); litigation on cargo lost at sea was pending against Target, but acquisition price was not reduced because of insurance and early success in litigation; Acquiror later paid to settle claim; payment capitalized in property acquired from Target; fact that "liability was contingent and unliquidated…is of no significance."
- *Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981) (*acq.*, AOD 1986-027). A cash basis Seller was treated as paying accounts payable assumed and paid by Acquiror, because Acquiror assumed liability for the payables instead of paying more cash. Acquiror's basis in the purchased assets would be increased by the amount of the payables.
- *Fisher Companies v. Commissioner*, 84 T.C. 1319 (1985), *aff'd without opinion*, 806 F.2d 263 (9th Cir. 1986). Amount realized on the sale of a building held increased by a price reduction due to Acquiror's assuming Seller's obligation to a lessee to repair the roof of the building.
- *Illinois Tool Works, Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004), *aff'g* 117 T.C. 4 (2001). Buyer's payment of $15 million judgment in a patent infringement case was capitalized where the liability was assumed from the seller of a business, even though the adverse judgment was a surprise. The Tax Court and the Seventh circuit both rejected a theory based on taxpayer's failure to settle case at less than $1 million. *See* P. Cook & M. Sperry, "Contingent Liabilities after *Illinois Tool Works, Inc.*, 2 Mergers & Acquisitions

12-20 (Nov. 2001); B. Raby & W. Raby, "Contingent Liability Payments in Business Purchases," 92 Tax Notes 941 (Aug. 13, 2001).

b. Timing of Liability

Did legal liability for the item arise before or after the acquisition? If so, was there substantial benefit to Acquiror 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 was added to basis (law changed by section 164(d)).
- *H. Hamburger Co. v. Commissioner*, 8 T.C.M. (CCH) 780 (1949). Payment of predecessor's debt to improve successor's credit rating held 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). Seller paid damages for concealing defects in property it transferred in like-kind exchange; the payment treated as capital loss under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); corollary would be reduction to Acquiror's purchase price.
- *David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981). Acquiror of Seller's assets assumed and paid Seller's pension obligation to the widow of a deceased former employee of Seller; payments held not deductible, even if timely made, but added to Acquiror's asset basis when made; *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44, followed; dictum in *F. & D. Rentals, Inc. v. Commissioner*, 365 F.2d 34 (7th Cir. 1966) rejected.
- *Hyde v. Commissioner*, 64 T.C. 300 (1978). Acquiror purchased property in foreclosure subject to a mortgage, then redeemed the property by paying the debt; taxes and interest accruing after purchase held deductible; pre-purchase taxes and interest held capitalized; mortgage redemption fee held deductible as interest. *See also* FSA 200048006 (Aug. 14, 2000) (in section 338(h)(10) stock sale, indemnification by Seller of Old T liability results in offsetting adjustments to New T's assets and deduction to Seller as Old T's successor).
- *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 payment was payment of loan, not deductible intangible drilling cost.

c. Surprise

Was Acquiror 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). Acquiror assumed lessee's obligation on lease, but lessee compensated Acquiror by transferring a building to it; even though Acquiror reported the value of the building as income when received, Acquiror'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*. *See* part IV.B.2.a., above.
- *Illinois Tool Works, Inc. v. Commissioner*. *See* part IV.B.2.a., above.

- P. Canellos, "Reasonable Expectations and the Taxation of Contingencies," 50 Tax Lawyer 299 (1997).

d. Litigation Costs

Presumably, under an "origin of the claim" analysis, the tax treatment of legal fees and other costs of administering and litigating assumed contingent liabilities would conform to the treatment of payments of the underlying liabilities themselves. A case dealing with deductibility of costs of litigating a dispute between corporate shareholders suggests this conclusion. Putnam-*Greene Financial Corp. v. United States*, 308 F.Supp. 2d 1374 (M.D. Ga. 2004).

3. Authorities on Employee and Retiree Compensation and Benefits

A number of authorities deal with compensation issues, such as pensions, vacation pay, employee stock options and retroactive wage increases. Regulations provide a "simplifying convention" relating to costs that "facilitate" an acquisition. Normally, these costs must be capitalized in the acquired assets. Under the regulations, however, compensation paid to employees (including bonuses and commissions) need not be capitalized even if the employees are compensated for work that facilitates an acquisition of an intangible. Reg. §§ 1.263(a)-4(e)(4)(ii), 1.263(a)-4(e)(5) Example (8). The same rule applies for compensation paid to employees to facilitate an acquisition of a trade or business (Reg. §§ 1.263(a)-5(d)(2)) and to employee compensation and overhead to acquire tangible property (Reg. § 1.263(a)-2T(f)(2)(iv)). This rule seems to allow Acquiror to deduct a wider range of employee compensation and benefits, to the extent attributable to services that are related to the acquisition itself. It does not affect the treatment of employee compensation or benefits for other services rendered to Seller or Acquiror.

a. Pensions – Retired Employees

Pensions paid by Acquiror to employees who were retired at the time of Closing are treated as liabilities assumed from Seller. *F. & D. Rentals v. Commissioner*, 365 F.2d 311 (7th Cir. 1966); *David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981); *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44.

b. Pensions – Employees Not Yet Retired

Pensions paid by Acquiror for employees not yet retired at the time of the acquisition are Acquiror's costs, deductible by Acquiror as incurred. *M. Buten & Sons v. Commissioner*.

c. Qualified Retirement Plan Contributions

Contributions to continue a qualified retirement plan (including meeting minimum funding standards and to fund plan liabilities not funded by Seller) are also Acquiror's costs and so are deductible. GCM 39274 (Aug. 16, 1984). *See also* PLR 7816063 (Jan. 23, 1978); PLR 8152055 (Sept. 29, 1981); PLR 8202115 (Oct. 16, 1981); PLR 8205022 (Nov. 3, 1981); PLR 8411106 (Dec. 16, 1983); TAM 8436002 (Mar. 23, 1984); 1994 FSA LEXIS 490 (May 9, 1994).

d. Retiree Medical Expense

Often retiree medical plans are revocable at any time. If so, should the payments be treated as deductible Acquiror's costs, because Acquiror makes the payments to improve worker morale and preserve the business? The treatment of pension plan expenses in GCM 39274 (Aug. 16, 1984) would support this idea. *See also H. Hamburger Co. v. Commissioner*, 8 T.C.M. (CCH)

780 (1949). *But see* FSA 1999-1068 (Oct. 8, 1993) (payment of assumed retiree health and life insurance benefits capitalized).

e. Retroactive Pay Increase

Retroactive pay increases are Acquiror's costs, deductible to Acquiror, if Acquiror 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).

f. Seller Employee Stock Options, SARs and Severance Pay

In this area, IRS has ruled that Seller, not Acquiror, may deduct items that Acquiror pays in connection with, or even after, the acquisition of Seller's business by Acquiror. In a taxable acquisition, Acquiror capitalizes the payment, and Seller must include the payment as an increase in its sale price for the business sold, with an offsetting deduction. If the payment is deferred compensation, the deduction may be delayed under section 404(a)(5).

- Rev. Rul. 73-146, 1973-1 CB 61. Seller deducts amounts paid by it to employees to terminate nonqualified stock options in connection with tax-free type-B reorganization. *See* J Starkey, "Tax Treatment of Employee Stock Options in Mergers and Acquisitions," 90 Tax Notes 1231 (Feb. 26, 2001). For further discussion of contingent liabilities in tax-free reorganizations, *see* part X., below.
- *Great Lakes Pipe Line Co. v. United States*, 352 F. Supp. 1159 (W. D. Mo. 1972). In connection with asset sale (tax-free under old section 337) and liquidation of Seller, Seller paid Acquiror cash to reimburse Acquiror for payments to Seller executives who had been terminated; payment held capital expenditure by Seller because obligation arose from asset sale.
- ISP Position Paper, Restricted Stock Purchase in Merger & Acquisition, 91 TNT 90-33 (Apr. 23, 1991). When terminating a restricted stock plan, Seller deducts the amount paid to employees that was vested prior to a plan amendment; amounts attributable to changes in plan made as part of acquisition plan must be capitalized as reduction to amount realized on sale.
- TAM 9125001 (Dec. 24, 1991), *modifying* TAM 8741001 (June 16, 1987). This technical advice memorandum establishes the IRS position that Seller may be entitled to an offsetting deduction for an assumed contingent liability that is included in its amount realized on a sale of a business. *See* part IV.D.2.a., below.
- TAM 9438001 (Apr. 21, 1994). Seller deducts amounts Acquiror paid to acquire Seller's employee stock options, stock appreciation rights, etc.
- TAM 9540003 (June 30, 1995). In connection with tender offer by Acquiror for Seller stock, Seller made payments to cancel its stock options and stock appreciation rights; amounts paid reflected "premium" in Seller stock value from Acquiror's offer; Seller deducts all amounts paid, including premium. *See also* FSA 200110020 (Dec. 6, 2000).
- TAM 9721002 (Jan. 24, 1997). Severance pay to Seller executives deductible to Acquiror, even though plan instituted by Seller in preparation for acquisition, because Acquiror, not Seller, decided to terminate executives. *See also* TAM 9731001 (Jan. 31, 1997).

- TAM 199923045 (Oct. 9, 1998). Seller employees were awarded cash performance units based on three years earnings, and they received the cash within 2½ months after the close of the third year. Awards were not "deferred compensation" and so were deductible by Seller in the third year under the "all events" and "economic performance" tests. Thus, it appears that, if the performance units had vested on or before an acquisition date, Seller would be entitled to the deduction.
- GLAM 2012-010 (Nov. 15, 2012). Nonqualified stock options and stock appreciation rights held by Seller employees were "cashed out" on the day the Seller stock was acquired (with no election under section 338(h)(10 or section 336(e)), and Seller joined a consolidated group. IRS concluded that the payments were subject to the "end-of-the-day" rule (Reg. § 1.1502-76(b)(1)(ii)(A)(1)), not the "next-day" rule (Reg. § 1.1502-76(b)(1)(ii)(B)) and were deductible on Seller's return for its year ending on the Acquisition date.

4. Alternative Analysis: Future Cost Embedded in the Property

A decision of the Supreme Court of Canada illustrates a different analysis of certain contingent obligations assumed in asset acquisitions. In *Daishowa-Marubeni International LTD. v. Canada*, 2013 SCC 29 (2013), Seller owned licenses to harvest timber (called "forest tenures") on certain tracts. Under provincial law, the areas in which timber was harvested had to be reforested. Seller sold the forest tenures, and Acquiror assumed the obligation to reforest land that Seller had harvested. According to provincial authorities, Seller was relieved of liability to complete the reforestation. Seller did not include any amount in income to reflect the value of this assumption, and the Minister of National Revenue assessed Seller for tax on the estimated cost of reforestation. The court held that Seller was not required to include the assumption in its income, because the obligation was not a separate liability: "The obligations—much like needed repairs to property—are a future cost embedded in the forest tenure that serves to depress the tenure's value at the time of the sale." The advantage of this analysis, from an administrative viewpoint, is that it removes future events from Seller's tax computations. Indeed, as the court points out, treating the reforestation obligation as part of sale price would have introduced asymmetry into the transaction: Seller's amount realized on the sale would include the assumed obligation, but Acquiror's basis in the property would not. This asymmetry exists under U.S. tax law, as this outline discusses.

C. Treatment of Acquiror Expenses Paid by Acquiror

If an expenditure is an Acquiror expense rather than an asumed liability, the treatment is the same as if there had been no acquisition. This "step-in-the shoes" treatment is simple and generally favorable to the parties, especially Acquiror.

1. Seller's Treatment

Because the payment is of Acquiror's own liability, there is no impact on Seller.

2. Acquiror's Treatment

Acquiror deducts or capitalizes the payment in accordance with accounting rules, as though there had been no acquisition.

D. Treatment of Seller Liabilities Assumed and Paid by Acquiror – "Assumption" or "Purchase" Model

If Acquiror assumes and pays a contingent liability previously incurred by Seller, the assumption and payment can be viewed for tax purposes as an adjustment that increases the price paid for the assets. This analysis, sometimes referred to as the "assumption" or "purchase" model, is the usual analysis. A much less common alternative, sometimes referred to as the "fragmentation" or "fee" model, is discussed in part IV.E., below.

Using the "assumption" or "purchase" model, the payment of the assumed liability by Acquiror is taken into account (usually as a deduction) by Seller, not by Acquiror. The only questions relate to timing: Is the increase in sale price estimated and taken into account at Closing or later when the liability becomes fixed or is paid? If the contingent liability results from a deductible cost, when is Seller entitled to the deduction? *See* part II.B.4.c., above.

Because there is no actual payment from Acquiror to Seller, this model is complicated for both parties. It leads to a series of alternative treatments, depending on the type of contingent liability involved. The aspect to watch is how the item would have been treated if it had stayed with Seller until it became fixed and was paid. For this purpose, we will consider the following categories of contingent liabilities:

- Items never deductible or recoverable by Seller, *e.g.*, Seller's Federal income tax liability or a fine or penalty subject to section 162(f).
- Items currently deductible by Seller, subject to normal accounting rules (the "all events test" and "economic performance" for accrual method taxpayers; payment for cash method taxpayers).
- Items deductible by Seller on a delayed basis, *e.g.*, deferred compensation under section 404(a)(5).
- Seller's capital items, *e.g.*, assumption of Seller indemnity from Seller's prior acquisition of asset later purchased by Acquiror from Seller.

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

1. Non-Deductible Expenditures

As an example of a non-deductible expenditure, after a purchase of stock subject to an election under section 338(h)(10) or section 336(e), Acquiror may have to pay an adjustment to Seller's Federal income tax liability from a pre-acquisition year (*e.g.*, a section 1374 tax on recognition of built-in gain by an S corporation or a payment by a former consolidated subsidiary under a tax sharing agreement) without indemnification. The usual analysis is that the payment is treated as an increase in the purchase price for the assets, resulting in a basis increase. Should this asset basis increase be reduced if there is an offsetting tax reduction in a post-Closing year (*e.g.*, if the tax liability resulted from capitalizing an expenditure that results in a future amortization deduction)?

a. **Consequences to Seller**

(1) **Expected Liability**

If Seller knows about the liability at Closing, Seller may adopt the installment method. In a section 338(h)(10) stock sale, under the prior section 338 regulations the installment method was not available, and there could have been an open transaction to Old T. Under current regulations, however, the results of a stock sale subject to an election under section 338(h)(10) or section 336(e) are the same as those of an actual asset sale. *See* parts II.B.2.b. and II*.A.2., above, and part IV.D.2.a., below. Thus, regardless of whether the sale is an actual asset sale or a stock sale with an election under section 338(h)(10) or section 336(e), if Old T elects out of the installment method, Old T may have to report the fair market value of New T's liability assumption as amount realized at Closing. No interest is imputed. When the liability is fixed or paid, Old T should realize the difference between the fair market value of the assumption (picked up at Closing) and the amount actually paid. It is not clear, however, whether this pickup is gain or loss on a separate contingent purchase price obligation (as in the closed transaction method) or additional purchase price on the asset sale.

(2) **Surprise Liability**

If the liability comes as a surprise after the Closing, Old T has additional amount realized on the sale when the liability is fixed or paid—as in any other open transaction except there is no imputed interest or original issue discount. Reg. § 1.1274-5. Does the delayed gain recognition mean that the installment method applies? The answer is not clear. The exception to imputed interest on assumptions of contingent liabilities suggests that this is a separate regime, so that it does not trigger the installment method. But the treatment remains uncertain.

b. **Consequences to Acquiror**

When the payment is made, Acquiror adds the amount paid to its cost basis in the assets and begins to take increased depreciation or amortization deductions at that time.

2. **Deductible Expenditures**

If an assumed liability is for an expenditure that is deductible (*e.g.*, most environmental remediation and employee benefit expenditures), Seller and Acquiror both treat the item as an increase in the price paid for the assets. Seller gets an offsetting deduction, with possible help as to timing under the economic performance regulations.

a. **Consequences to Seller –Increase in Taxable Amount Realized and Offsetting Deduction**

Seller has an increase in its taxable gain (or a decrease in its loss) but also should have an offsetting deduction as though it had paid the liability itself.

Reg. § 1.1001-2(a)(1) and extensive case law (discussed in part IV.B.1., above) make clear that Acquiror's assumption of Seller's liability is treated as part of Seller's amount realized on the sale of the property.

In TAM 8741001 (June 16, 1987), *modified*, TAM 9125001 (Dec. 24, 1990), before a stock sale with a section 338(g) election, Old T had accrued but not yet paid vacation pay and estimated warranty service expenses. New T was deemed to assume these liabilities under the section 338(g) election. IRS added the assumed liability amounts to the amount realized at Closing of the deemed asset sale. IRS allowed Old T to deduct the fixed vacation pay liability at the time of the acquisition. IRS went on, however, to interpret Old Reg.§ 1.338-3(h)(1)(i) as denying any deduction for the warranty service expenses to both Old T or New T. The warranty service deduction was denied, because the claims were contingent at the time of sale (*i.e.*, the expenses did not meet either the "all events" test or the "economic performance" test), and, before these tests were met so that the deductions could be taken, Old T had disappeared in a deemed liquidation, as a result of the section 338(g) election.

Controversy resulted from this harsh conclusion. In TAM 9125001, IRS modified TAM 8741001 and interpreted Old Reg.§ 1.338-3(h)(1)(i) as allowing New T to deduct the contingent liability. The time of the deduction was not specified, however. (*See* parts IV.D.2.b.(3) and IV.D.2.b.(4), below).

The current regulations allow the deduction to Old T (or to its successor, Seller) in a section 338(h)(10) stock sale and to New T after a section 338(g) election. Reg. §§ 1.338-2(c)(7) (broad definition of "deemed sale tax consequences" to include deductions), 1.338-7(c)(1), 1.338-7(e) Example (1) (availability of deduction for payment of contingent liability not specified). For discussion of "deemed sale tax consequences," *see* part II.B.4.c., above. *See also Flood v. United States*, 133 F.2d 173 (1st Cir. 1943), and Rev. Rul. 75-154, 1975-1 CB 186 (pension payments made by former partners to former employees of terminated partnership deductible by partnership, even though partnership had sold its business).

b. Treatment of Seller – Timing

(1) Inclusion in Amount Realized

It appears that Seller's contingent liabilities assumed by Acquiror are included in amount realized at Closing. Apart from section 453 itself, however, there is no authority directly on point.

(a) Inclusion at Closing

Treating the liability assumption as amount realized at Closing would be consistent with the treatment of contingent purchase price under the closed transaction model, if Seller elects out of section 453. *See* part I.C.2., above.

(b) Deferral of Inclusion Until Liability Is Fixed or Paid

Waiting until a liability becomes fixed before including it in Seller's amount realized would be consistent with the exclusion of assumed contingent liabilities from the imputed interest/original issue discount regime and with the treatment of unaccounted-for acquisition debt under Reg. § 1.1001-2(a)(2).

(c) Deferral of Inclusion under Installment Method

If Seller uses the installment method, Acquiror's payment of the contingent liability will be an installment payment and will be included in Seller's amount realized at the time of payment.

(d) Overall Consequences to Seller

Treating Acquiror's assumption of contingent liabilities as amount realized at Closing could have harsh results for Seller. The amount realized on the assumption of the contingent liability would be offset by the corresponding deduction only later (perhaps much later) when the liability accrues under the "all events" test, and the economic performance test is met, *i.e.*, usually when the liability becomes fixed and is paid. *See* part IV.D.2.a., above.

If assumption of contingent liabilities by Acquiror is treated in the same way as contingent purchase price under the open transaction method (*see* part I.C.3., above), Seller would not recognize any loss on the sale until all the contingencies have become fixed (in an open transaction). This harsh result would apply unless the assumption is treated as a closed transaction at the Closing of the sale with no further adjustments as the contingencies become fixed.

If Acquiror's payment of the contingent liability is treated as a payment under the installment method, the effect on the recovery of Seller's basis is uncertain. *See* part I.B.3.e., above.

(2) Amount Included

There is no original issue discount or imputed interest as to assumed contingent liabilities. Reg. § 1274-5. Nevertheless, the fair market value of the liability assumption would have to be discounted taking into account, along with the contingencies, the time value of money.

(3) Reg. § 1.461-4(d)(5)

Reg. § 1.461-4(d)(5) provides that, when there is an express assumption by Acquiror of Seller's business liability in a purchase of a business, the economic performance test for Seller is satisfied at the time Seller includes the assumed item in its amount realized. Thus, Seller gets its deduction on these items when the liability becomes fixed and thus meets the "all events" test for accrual, even if not yet paid by Acquiror. More important, the deduction and the increase in sale price occur at the same time, so that phantom gain to Seller is offset with a simultaneous deduction.

But the regulations have limited scope. They provide only that, if the stated conditions are met, the economic performance requirement imposed by section 461(h) of the Code is satisfied. For an item to be deducted, it must satisfy both the economic performance test and the traditional "all events" test under the accrual method (Reg. § 1.461-1(a)(2)). A contingent liability item typically would not meet the "all events" test. (*But see* part IV.D.2.b.(4), below, for an example of a contingent liability that is considered fixed enough to meet the all events test.) In addition, the regulations "reserve" on the treatment of contingent liabilities. Reg. § 1.461-4(j). Do these rules mean that the "offset" deduction provided for in Reg. § 1.461-4(d)(5) applies only to liabilities that are fixed at the time of Closing? If so, the offset does not often apply, and, if Seller must include the fair market value of Acquiror's assumption of a contingent liability in its amount realized at Closing, there will be a timing mismatch as between the gain item and the deduction. *See* part IV.D.2.b.(1)(a), above.

(4) Sale of Nuclear Power Station

IRS appears sympathetic to preventing timing mismatch to the Seller, at least where the contingent liability is fixed as a practical matter. In PLR 200126011 (Mar. 26, 2001) and in several similar rulings,* Seller sold a nuclear power station, including cash and investment assets

* Dozens of such rulings have been issued. *See, e.g.*, PLR 200302013 (Sept. 30, 2002); PLRs 200302009 through 200302012 (Sept. 27, 2002); PLR 200218019 (Jan. 30, 2002); PLR 200215037 (Jan. 14, 2002); PLR 200125066 (Mar. 26, 2001); PLR 200125007 (Feb. 20, 2001); PLR 200121028 (Feb. 20, 2001); PLR 200042006 (July 11, 2000); PLR 200037020 (June 9, 2000); PLRs 200034007-08 (Aug 28, 2000); PLR 200034009 (May 18, 2000); PLR 199943041 (July 21, 1999); PLR 199952074 (Sept. 28, 1999).

in a non-qualified fund, and Acquiror assumed liability for decommissioning the plant in the distant future. As to Seller, IRS ruled that the present value of the assumed decommissioning liability was included in Seller's amount realized on the sale, but that the decommissioning liability was sufficiently fixed so that Reg. § 1.461-4(d)(5) accelerated the deduction to match this additional amount realized. Pursuant to regulations dealing only with sales of nuclear power stations, the Acquiror's treatment may be changed by election. Reg. § 1.338-6(c)(5). These regulations are discussed further in part IV.D.2.e., below.

c. Consequences to Seller – Effect on S Corporation Built-In Gain

If Seller is an S corporation, it will be subject to corporate-level tax on its net recognized built-in gains (recognized built-in gains less recognized built-in loss) in each year for 10 years after its election becomes effective (shorter periods for gain recognized in 2009-2013). If, before the S election, Seller sold a business with Acquiror assuming a contingent liability, the results can be surprising. The reason is that an expenditure or other cost (other than a loss on a sale of property) is treated as a recognized built-in loss only if the cost would have been eligible for deduction before the S election under the accrual method. Reg. § 1.1374-4(b)(2).

Example. Seller, an S corporation, sells a business and recognizes built-in gain, with Acquiror assuming contingent liabilities, during the section 1374 gain recognition period. Later, but still during the gain recognition period, the contingent liability becomes fixed, and Acquiror pays it. If Seller uses the installment method, the gain recognized to Seller when Acquiror pays the assumed liability will be built-in gain. Reg. § 1.1374-4(h). The offsetting deduction, however, would seem not to qualify as a recognized built-in loss, because it would not have been allowed as a deduction under the accrual method before Seller's election. The result would be taxable corporate-level gain to Seller with no offset to reflect Seller's entitlement to a deduction if Seller had paid the liability itself. If Reg. § 1.461-4(d)(5) (*see* part IV.D.2.b.(3), above) applies to the payment, the deduction may qualify as a built-in loss, but, apart from the uncertainty regarding application of that regulation, there are no authorities on this point. Note also that, if Acquiror's payment takes place after the gain recognition period, the built-in gain will still be taxed under section 1374, due to special rules that apply to installment sales (Reg. § 1.1374-4(h)(1)), but there appears to be no offsetting built-in loss from the deduction.

d. Consequences to Seller – Loss Carryback

If the expenditure is for a "specified liability loss," Seller may be eligible to carry back a loss for 10 years instead of the usual two years, under section 172(b)(1)(C) and (f). These expenditures include product liability losses and "deferred statutory liability losses," which include certain costs for land reclamation and environmental remediation. In the case of the costs of decommissioning a nuclear power plant, the loss may be carried back all the way to the year in which the plant was placed in service.

Several of these rulings are discussed in J. Cummings, "Capitalization—Selling Nuclear Decommissioning Funds," 195 DTR J-1 (Oct. 12, 2010).

e. Consequences to Acquiror

(1) General

Acquiror obtains basis and begins 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); Rev. Rul. 80-235, 1980-2 CB 229 (nonrecourse note not included in basis because speculative); PLR 9313025 (Jan. 5, 1993); PLR 9317005 (Jan. 15, 1993) (note under Federal clean coal program not included in basis).

(2) Acquisitions of Nuclear Power Stations – Basis Computation

In PLR 200126011 (Mar. 26, 2001) and the other rulings cited in footnote *, above, IRS ruled that the liability to pay the costs of decommissioning a nuclear power station was contingent and so could not be reflected in the basis of the station until the liability became fixed. *Cf. Merkel v. Commissioner*, 192 F.3d 844 (9th Cir.1999) (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 he would be called upon to pay them; discounting of liability for this purpose by probability of occurrence rejected).

Nuclear power station decommissioning costs must be fully-funded in a trust. In connection with a sale of a nuclear power station, Acquiror assumes the liability for decommissioning costs, and the investment assets in this trust are transferred to Acquiror. Acquiror may not withdraw assets from the trust except to fund the decommissioning expenditures.

According to IRS, under the section 1060 regulations the price paid by Acquiror is allocated to the funds in the trust (Class I or Class II assets) before any amount can be allocated to assets comprising the power station itself (Class V). *See* part II.C., above. Also, the liability for decommissioning funded by the trust is not included in Acquiror's basis until actual decommissioning—when both the requirements for general accrual and economic performance are satisfied.

This treatment of Acquiror is noteworthy in two respects:

- Seller is required to include the present value of the assumed decommissioning liability in its amount realized at closing, but it is entitled to an immediate, offsetting deduction. *See* part IV.D.2.(b)(4), above. The delay in including the same liability in Acquiror's basis is, if nothing else, inconsistent with Seller's treatment.
- Decommissioning could take place decades after Closing. If the decommissioning liability and the amount of the trust funds are large enough, the trust funds could absorb most or all of purchase price and leave little or no depreciable basis for the power station assets. Thus, Acquiror is left having expended cash with no depreciation or other recovery for decades. The amount of trust funds could even exceed the entire amount included in Acquiror's basis, so that Acquiror would have no depreciable basis and would be taxed on gain at the time of Closing.

In litigation in the U.S. Court of Federal Claims, IRS reaffirmed its position, as to both (i) the inclusion of the trust funds transferred to Acquiror in the section 1060 basis allocation and (ii) the delay of including the decommissioning expense liability in basis until the expenses are incurred. *AmerGen Energy Co. LLC v. United States*, Dkt. No. 09-108-T Jt. Prelim. Status Rpt. (Dec. 7, 2009). In that case, it appears that the taxpayer, the Acquiror of three nuclear power stations, did not contest the IRS position that the trust funds transferred to it were included in its section 1060 basis allocation, but it argued that it was entitled to add the decommissioning liability to its basis immediately. The taxpayer argued that its decommissioning liability was sufficiently fixed to satisfy the general requirements for accrual, and that the economic performance requirement does not apply to the computation of asset basis (or alternatively, if this requirement does apply, it was met). *See* J. Cummings, "Capitalization—Selling Nuclear Decommissioning Funds," 195 DTR J-1 (Oct. 12, 2010). The court rejected the taxpayer's arguments and held that, because of the economic performance requirement, the taxpayer could not include the decommissioning liability in its basis until the power station was decommissioned, and the expenditures were incurred. *AmerGen Energy Co. LLC v. United States*, 112 AFTR 2d 2013-6376 (Ct. Fed. Cl. 2013) (appeal pending).

In a case involving the obligation to dismantle and remove the Trans-Alaska Pipeline System and restore the land when the pipeline ceased operating, the 10th Circuit adopted the same view of the economic performance requirement. *United States v. ConocoPhillips Co.*, 744 F.3d 1199 (10th Cir. 2014).

(3) Acquisition of Nuclear Power Station – Election under Reg. § 1.338-6(c)(5)

To mitigate the harsh result of the IRS position, upheld in *AmerGen*, Treasury and IRS adopted temporary regulations in 2004 (Reg. § 1.338-6T, TD 9158, 69 Fed. Reg. 55,740 (Sept. 16, 2004)) and final regulations in 2007 (Reg. § 1.338-6(c)(5), TD 9358, 72 Fed. Reg. 51,703 (Sept. 11, 2007). Under both the temporary and final regulations, in an acquisition of a nuclear power station, Acquiror may elect unilaterally to treat the nonqualified fund trust as a separate corporation which owns the investment assets and is the obligor of the decommissioning liabilities. Acquiror is treated as purchasing the stock of this corporation with a section 338(h)(10) election, regardless of whether the requirements for the election are met. Thus, it does not matter whether Acquiror is a corporate purchaser" (as required for a "qualified stock purchase"), and the section 336(e) regulations have no role in the election. Seller's tax treatment of the sale is not affected.

As a result, if the value of the investments in the trust is equal to the present value of the estimated decommissioning liability, Acquiror is deemed to pay $0 for the stock. Since the stock deemed purchased is a class V asset, the amount actually paid by Acquiror is allocated to the assets of the power station itself.

The election available under the regulations solves the problem of distortion in the basis allocation under section 1060, but it exacts a heavy price: The election causes investments in the nonqualified trust to have a $0 basis. As investments turn over or cash is spent, gain is recognized equal to the full amount realized on the investments or the spent cash, not just on economic gain. G. Pavin & G. Towne, "Basis Distortions on Nuclear Power Plant Purchases," 106 Tax Notes 565 (Jan. 31, 2005). Obviously, this aspect of the election will distort Acquiror's decisions regarding investment of the funds. Indeed, virtually any investment other than cash or instruments with terms as long as the expected life of the power station could result in acceleration of tax liability.

Moreover, the election under the regulations has no effect on the economic performance problem. With or without the election, if the IRS position expressed in the private rulings and upheld in *AmerGen* prevails, Acquiror may not include its decommissioning liability in the basis of the assets, with or without the election.

Finally, the election is available only for a purchase of a nuclear power plant. Taxpayers in similar situations, such as those in *ConocoPhillips*, are entitled to no relief.

(4) Acquisition of Nuclear Power Station – Alternative Analysis of Transferred Funds

The IRS position, expressed in its private rulings, including those cited in footnote *, above, is that the funds to provide for the decommissioning expenditures are transferred by Seller to Acquiror along with the other assets of the power station and are included as assets to which basis must be allocated under section 1060. As the discussion above shows, this position accounts for all the parts of the transaction. In particular, the IRS position appears to emphasize the fact that, if funds remain after the decommissioning expenditures are made, those funds are transferred to Acquiror's unrestricted use. As also discussed above, however, the practical consequences of this position to Acquiror continue to be harsh.

An alternative analysis is that the funds constitute security for an indemnity by Seller to Acquiror for decommissioning expenditures up to the amount of the transferred funds. As a result, the funds would not be treated as transferred to Acquiror, and Acquiror would not be treated as assuming that portion of the decommissioning cost liability. *See* discussion of indemnities in part IV.G., below. Thus—

- The funds would not be part of the section 1060 basis allocation.
- Income earned on the funds would be taxed to Seller or to a separate entity, not to Acquiror.
- Acquiror would never be entitled to a deduction or basis increase for the decommissioning expenditures made out of the funds.
- If the funds are not sufficient to pay all the decommissioning costs, and Acquiror spends its own funds, Acquiror would be entitled to basis increases at that time for those expenditures.
- Similarly, if the funds are more than sufficient to pay the decommissioning costs, and Acquiror becomes entitled to the extra funds. Acquiror would be taxed on such funds at that time.
- The distortion arising in the Reg. § 1.338-5(c)(5) election would be avoided, because the funds (and investments thereof) would retain their historic basis.

This alternative analysis would account for all parts of the transaction but with different emphasis. It would emphasize the fact that Acquiror does not have unrestricted use of the funds, because the funds must be used to pay decommissioning costs. Moreover, this analysis could apply to any funds dedicated to paying future environmental remediation and reclamation type costs—not just nuclear power plant decommissioning costs.

f. Character of Payments

There is no imputed interest on assumption of contingent liabilities. Reg. § 1.1274-5(a). Thus, as compared with a contingent purchase price, there is an artificial deferral of deductions to

Acquiror, as well as a conversion of ordinary interest income into sale income (usually capital gain) to Seller.

3. Delayed Deductible Items

Payment of an assumed liability item may be deductible to Seller but with special restrictions as to timing. As a common example, section 404(a)(5) delays the deduction for deferred compensation paid by an accrual method taxpayer until the employee's taxable year during which he or she is required to report the income. Section 409A, enacted in 2004, accelerates the taxability of deferred compensation in some situations. To this extent, section 409A narrows the scope of section 404(a)(5). It is reasonable to expect, however, that employers will go to some lengths to maintain deferral by complying with the section 409A requirements. Thus, the possible timing mismatch between Seller's inclusion in amount realized and the offsetting deduction remains a problem.

a. Deferred Compensation under Section 404(a)(5) – Seller

If the fair market value of the deferred compensation payment can be determined, Seller may have an increase in its amount realized at Closing. *See* part IV.D.2.a., above. Seller may not be entitled to the deduction for the deferred compensation, however, until the employee is paid and includes the payment in income. TAM 8939002 (June 15, 1989). Reg. § 1.461-4(d)(5), which was adopted after the issuance of TAM 8939002, could be read as allowing this deduction at the time the amount is included in Seller's amount realized in the sale. Although there is doubt on this point, this interpretation gains strength from Reg. § 1.461-4(d)(2)(ii)(A), which defers the deduction but only to extent not otherwise provided in regulations, revenue procedures or revenue rulings. In a report on the proposed regulations that became Reg. § 1.461-4, the New York State Bar Association argued that, in connection with the sale of a business, Seller should be allowed its deduction at the same time it includes the assumed liability in its amount realized. NYS Bar Ass'n Tax Section Committee on Tax Accounting Matters, "Report of Proposed Regulations Relating to Economic Performance Requirements," 90 TNT 242-21 (Nov. 7, 1990). After this report was submitted, the proposed regulations were modified to broaden the scope of what is now Reg. § 1.461-4(d)(5) and to add the carve-out language to Reg. § 1.461-4(d)(2)(iii)(A). *See also* TAM 199923045 (Oct. 9, 1998), discussed in part IV.B.3.f.(8), above, dealing with the scope of "deferred compensation." Nevertheless, the issue remains in doubt.

b. Deferred Compensation under Section 404(a)(5) – Acquiror

If Acquiror assumes a deferred compensation liability, Acquiror gets asset basis, but its depreciation deduction begin only upon payment to the employee or perhaps when Seller includes the liability in its amount realized on the sale. *See* part IV.D.2.c., above.

4. Capital Items of Seller

An example of a Seller capital item occurs if Acquiror assumes Seller's obligation to pay a contingent purchase price or indemnity payment on a prior acquisition by Seller. Presumably, Seller would capitalize the payment in its purchase price related to the prior acquisition, and Seller would increase its sale price in the later acquisition. But, under Reg. § 1.1001-1(g)(2), if the Seller's obligation arose from the acquisition of the assets, and if Seller has not yet taken the obligation into account in the basis of the acquired assets, the obligation is not included in the Seller's amount realized on the sale. Query: Why should acquisition obligations be treated differently from other contingent obligations?

E. Treatment of Seller's Liabilities Assumed – "Fee" and "Fragmentation" Models

As an alternative to the "purchase" or "assumption" model discussed in part IV.D., above, Seller may be viewed as paying Acquiror to assume its contingent liability at Closing. The payment is generally viewed as consisting of a reduction in the price for the assets sold. This version of the model is sometimes referred to as the "fee" model. In another version, Seller is viewed as compensating Acquiror for assuming the liability in kind, *i.e.*, in the form of a portion of the assets sold in the transaction. Because the sale transaction is bifurcated into a sale component and a payment in kind, this version is sometimes referred to as the "fragmentation" model.

1. Prior Use of Fee Model

The fee model was occasionally employed in asset sales under pre-1986 section 337. Under that provision, the deemed offsetting increase in sale price was not recognized as gain to Seller. At the same time, Acquiror would realize taxable income by purchasing the business and being deemed to receive the fee for assuming the liability. *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964) (where Acquiror assumed Seller's obligation to provide subscribed-for newspapers, Seller was treated as receiving a higher price and then paying back part of the price to Acquiror as a deductible expense; Acquiror's tax treatment was not addressed directly, because Acquiror was not before the court). In Rev. Rul. 68-112, 1968-1 CB 62, also dealing with a sale of a newspaper, IRS adopted the *James M. Pierce Corp.* analysis on the Seller side, ruling that Seller was entitled to a deduction for the hypothetical payment and repayment of part of the sale price. In Rev. Rul. 71-450, 1971-2 CB 78, IRS amplified Rev. Rul. 68-112 and applied the same reasoning to tax Acquiror on the same amount. These rulings were controversial within the government. *See* GCM 34418 (Feb. 3, 1971) (background to Rev. Rul. 71-450; Chief Counsel reaffirms *James M. Pierce Corp.* and Rev. Rul. 68-112 in response to Department of Justice concerns).

A few years later, in Rev. Rul. 76-520, 1976-2 CB 42, dealing with a subsidiary liquidation of a periodical publishing corporation under section 334(b)(2), as then in effect, IRS ruled that the parent corporation had to capitalize the expenses it incurred after the liquidation to complete the subscriptions to the former subsidiary's periodical. No mention was made of section 455, *James M. Pierce Corp.*, Rev. Rul. 68-112 or Rev. Rul. 71-450, or of a current deduction to the liquidating subsidiary or taxable income to the parent at the time of the liquidation. This ruling could suggest that the *James M. Pierce Corp.* analysis is applied only where Seller had elected to defer income on pending subscriptions under section 455.

2. Current Use of Fee and Fragmentation Models

For many years, the fee model was applied only in the publishing industry to account for prepaid subscription income deferred under section 455. TAM 9823002 (Feb. 5, 1998) (subscription income deferred by partnership treated as partnership "liability" that increases basis in partnership interests). The fee model now may apply to deemed asset sales between insurance companies. Such transactions would be taxed as assumption-reinsurance transactions. Reg. §§ 1.338-1(a)(2), 1.338-11.

In a preamble to final regulations (TD 9376, 73 Fed. Reg. 2416, 2417 (Jan. 16, 2008)), the government applied the fee model (including taxable income to Acquiror) when Acquiror assumes Seller's obligation to provide goods or services for which Seller has received but deferred taxable income (*James M. Pierce Corp.*). Although the regulations themselves deal with the treatment of minority shareholders in section 332 liquidations (Reg. §§ 1.1502-80(g)(2), 1.1502-80(g)(6) Example 3), the reasoning in the preamble would seem to apply to asset sales as well. *See* GCM 34418 (Feb. 3, 1971). Neither the preamble nor the regulation applies, however, to assumptions of other contingent liabilities.

In recent years, interest in the fee and fragmentation models has increased. *See* R. Scarborough, "Property Purchase or Payment in Kind? The *Oxford Paper* Conundrum," Tax Forum No. 608 (May 5, 2008); N.Y.S. Bar Ass'n Tax Section Rpt. No.1281, "Report on Tax Treatment of 'Deferred Revenue' Assumptions by the Buyer in Taxable Asset Acquisitions" (Jan. 7, 2013); R. Feldgarden, "Assuming the Liability to Provide Property or Services in a Purchase," 138 Tax Notes 1153 (June 2013); G. Cohen, "Deferred Revenues in Partnership and Corporate Acquisitions," 143 Tax Notes 201 (Apr. 2014); J. Cummings, "Paying for Assumption," 143 Tax Notes 487 (Apr. 2014). This interest has been largely confined to prepaid income and similar situations, but the same analysis could apply to assumptions of actual contingent liabilities.

3. Consequences of Fee and Fragmentation Models

Application of the fee and fragmentation models is extremely complex. In the post-*General Utilities* world, both versions are unfavorable to Seller and to Acquiror.

a. Consequences to Seller

In both the fee model and the fragmentation model, Seller is deemed to compensate Acquiror for assuming the contingent liability, and that deemed compensation is taken into account separately, but in different forms.

- In the fee model, Seller adds the fair market value of Acquiror's liability assumption to its amount realized in the asset sale. Seller is also deemed to make an offsetting payment to Acquiror in the same amount, to compensate Acquiror for assuming the liability. The character of the deemed offsetting payment has not been explored. It could have the same character as an actual payment by Seller of the underlying obligation, as discussed in part IV.D., above:
  - If a payment by Seller of the underlying obligation would be non-deductible (*e.g.*, a Federal income tax payment as discussed in part IV.D.1., above), the deemed payment by Seller to Acquiror also should be non-deductible to Seller.
  - If a payment by Seller of the underlying obligation would be deductible currently (as discussed in part IV.D.2., above), the deemed payment by Seller to Acquiror also may be deductible to Seller at the time of Closing, pursuant to Reg. § 1.461-4(d)(5). However, as discussed in part IV.D.2.b.(3), above, the scope of this regulation, and therefore the timing of the deduction, is not clear.
  - If a payment by Seller of the underlying obligation would be deductible on a delayed basis (*e.g.*, deferred compensation under section 404(a)(5), as discussed in part IV.D.3., above), the deemed payment by Seller to Acquiror should be deductible to Seller subject to at least the same deferral.
  - If a payment by Seller of the underlying obligation would be a capital item to Seller (as discussed in part IV.D.4., above), the deemed payment by Seller to Acquiror should be treated as part of the same capital asset, *i.e.*, a reduction in the amount realized on (or an increase in the basis of) the asset.

The fee model is the version used by the courts in *James M. Pierce* and *Commercial Security Bank* (*but see* AOD 1986-027 for an adverse reaction by IRS).

- In the fragmentation model, Seller is deemed to transfer the assets sold to Acquiror in two tranches: one for the actual purchase price and the other for Acquiror's assumption of the contingent liabilities. This is the version favored by Robert Feldgarden in his article cited in part IV.E.2., above.
- As a third possible version, the deemed payment could be treated as a separate asset transferred to Acquiror as part of the asset sale. Would this asset be Class I (cash) or Class V (a non-marketable financial instrument deemed issued by Seller)?

b. Consequences to Acquiror

The fee and fragmentation models have offsetting consequences to Acquiror as well:

- In both the fee model and the fragmentation model, Acquiror may have taxable income for the payment it is deemed to receive from Seller at Closing. Then, when the liability is paid or accrued, Acquiror should have a deduction or loss for the payment.
- In the fee model, Acquiror is deemed to increase its purchase price for the assets at Closing. Acquiror should be able to depreciate or amortize the assets taking the deemed payment into account immediately, even though the liability is contingent (*see* part IV.D., above), because Acquiror would be considered to have paid this amount for the purchased assets and received it back in a separate transaction.
- In the fragmentation model, Acquiror is deemed to purchase one tranche of the assets for cash and to receive the other tranche of assets in exchange for its assumption of Seller's contingent liabilities. Acquiror would take a fair market value basis in all the assets.
- In the third version of the fee or fragmentation model, the deemed payment by Seller to Acquiror is a Class I or Class V asset under section 1060. In this version, Acquiror's total asset basis would include its deemed payment to Seller, but the section 1060 allocation of this basis would include the Class I or Class V asset. Thus, in effect, Acquiror's depreciable basis would not include the value of its assumption of the contingent liability.

c. A Suggested Tweak

If the fee or fragmentation model is used, the results would be more sensible if the analysis were limited to Seller (gain and offsetting deduction), while Acquiror is allowed a step-up in the basis of the purchased assets subject to the normal accounting rules applicable to assumptions of fixed or contingent liabilities.

F. Treatment if Seller's Liabilities Assumed – Alternative Analyses

All the models under current law are difficult to apply, especially the fee or fragmentation model, and it is tempting to come up with a simpler approach.

1. Acquiror Steps into Seller's Shoes

Some commentators have proposed allowing Acquiror to step into Seller's shoes and take deductions when Seller otherwise would have been allowed the deductions. 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; NYSBA Tax Section Committee on Alternative Minimum Tax, "Report on the Federal Income Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions," 49 Tax Notes 883 (Nov. 19, 1990).

- This system would have the advantage of keeping Seller out of the matter. Seller may not be able to find out about the contingent liabilities that become fixed after the Closing, at least if there is no indemnity.
- This system would treat a contingent liability differently from a fixed liability or contingent purchase price and as more like an unfavorable executory contract or other 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). An example of this type of analysis appears in PLR 200730014 (July 27, 2007). There, a purchaser of a gas marketing business paid customers to terminate their contracts to buy gas at low fixed prices and substitute contacts to buy at fluctuating prices. IRS ruled that, even though the contracts were unfavorable to the purchaser, the payments could be deducted currently, because the purchaser's obligations were contingent on gas purchases and market fluctuations, and because the contracts were not taken into account in determining the purchase price for the business. The Supreme Court of Canada adopted this analysis in *Daishowa-Marubeni International Ltd. v. Canada*, 2013 SCC 29 (2013) (Acquiror of timberland assumed reforestation obligation; assumption not added to Seller's amount realized, because obligation was a future cost that depressed value of purchased property, not a liability).
- In the case of a non-deductible expenditure, a step-into-the-shoes approach would benefit Seller at the expense of Acquiror, because of the absence of a purchase price adjustment.
- In fact, this is probably what many parties actually do, by treating assumed liabilities or Acquiror expenditures, and IRS seems not to have been active in challenging this result.

2. Surprise Expenses

One commentator has suggested allowing a step-in-the-shoes 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 Law. 299 (1997). The Tax Court and the Seventh Circuit have rejected this analysis, however, and required Acquiror to capitalize the cost of an unexpected judgment against it in a patent infringement case. *Illinois Tool Works, Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004).

3. Discounted Deduction

Other commentators have argued that a step-into-the-shoes approach would allow Acquiror the benefit of deductions sooner than is appropriate, because Acquiror would get an immediate full deduction, not depreciation. As a result, they suggest a discounted deduction or "haircut" for Seller liabilities assumed by Acquiror. 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). This approach too would exclude Seller from the matter.

G. Possible Future Guidance

The general treatment of assumption of contingent liabilities was a listed project in the Treasury-IRS Business Plan for 1995, but it was deleted from the 1996 Business Plan. It has not been listed on a Business Plan or a Priority Guidance Plan since that time. However, two projects on related subjects are listed in the most recent Priority Guidance Plan:

- "Regulations under §451 regarding advance payments received for goods and services, including amounts received in exchange for the sale or issuance of gift cards, trading stamps, and loyalty points that can be redeemed for goods and services."
- "Guidance regarding the treatment of deferred revenue in taxable asset sales and acquisitions."

Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Tax Accounting ¶¶ 12, 22.

H. Treatment of Indemnity Payment by Seller to Acquiror

Pursuant to an asset acquisition agreement, Seller may be required to indemnify Acquiror for expenditures or to retain certain contingent liabilities relating to the acquired assets.

1. Seller's Treatment of Indemnity Payment When Made

Indemnity payments by Seller to Acquiror that integrally relate to or arise from an asset sale transaction itself, such as payments made for breaches of contractual representations or warranties, are treated as reductions in sale price, under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952). *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422 (1949) (payments and attorney fees paid for breach of warranty claim from real estate sale treated as capital losses relating back to sale); *Rees Blow Pipe Manufacturing Co. v. Commissioner*, 41 T.C. 598 1964 (*nonacq.*), *aff'd per curiam*, 342 F.2d 990 (9th Cir. 1965) (payment made pursuant to legal claim arising from non-taxable capital asset exchange treated as relating back to exchange); *Boothe v. Commissioner*, 768 F.2d 1140 (9th Cir. 1985, *rev'g* 82 T.C. 804 (1984) (payments made pursuant to breach of warranty claim on capital asset sale treated as relating back to sale).

In the more common situation, an indemnity payment does not integrally relate to the transaction. Rather, it funds a liability arising from the operation of the business that is sold in the transaction, and the payment would have been a deductible business expense to Seller if no sale of the business had occurred. In this situation, Seller generally continues to be entitled to an ordinary deduction for these indemnity payments. For example, in *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943), former partners were entitled to deduct payments of retained pension liabilities after the sale of their former partnership's assets. *See* also Rev. Rul. 75-154, 1975-1 CB 186 (permitting former partners to deduct retirement payments to a retired former partner after the termination and liquidation of their former partnership); PLR 200127022 (Apr. 4, 2001), (doctor sold practice but violated restrictive covenant; IRS ruled that his payment of damages was deductible, because the payments arose from business operations rather than relating back to sale).

2. Acquiror's Treatment of Indemnity Payments When Received

If Seller continues to be entitled to deduct its indemnity payment relating to a retained liability under Flood, Acquiror should be treated as if it had never assumed the Seller's liability, to the extent of the indemnity. Therefore, Acquiror would not be entitled to a deduction for the expenditure, would not have income for receipt of the indemnity and would not make any adjustment to asset basis for either the expenditure or receipt of the indemnity. *Rogers v.*

Commissioner, 5 T.C. 818 (1945) (real property Seller covenanted that property tax had been paid; state law change resulted in additional pre-sale tax; Buyer paid tax, and Seller defaulted on covenant; held, Buyer allowed bad debt deduction and not required to add tax to property basis); *Columbus and Greenville Ry. v. Commissioner*, 42 T.C. 834, 849 (1964) *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966) (acquired property subject to mortgage on which another party was also liable; taxpayer's liability was absolved without payment in consideration of its contingent agreement to sell property to the other obligor for "the amount which the present owners have put into the property"; no part of mortgage added to property basis for depreciation purposes).

This no-assumption analysis is supported by the policy behind section 357(d), which focuses on which person is likely to pay an obligation with more than one obligor. Although section 357(d) applies to tax-free section 351 incorporations and corporate reorganizations, and not to taxable asset sales, the policy is grounded in economic reality and, in section 357(d)(3), Congress authorized regulations to apply section 357(d) to other transactions such as taxable asset acquisitions.

The no-assumption analysis is also consistent with the rationale expressed in *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), and in *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (corporate transferee assumed liability for shareholder notes, but assumption not taken into account until corporation repaid notes, because shareholder remained liable).

IRS has described a minor variation on this treatment of indemnified contingent liabilities, *i.e.*, that Acquiror has an increase in its basis in the acquired assets to account for an assumption of the liability and an offsetting reduction in asset basis to account for the indemnity. FSA 200048006 (Aug. 14, 2000).

3. Possible Alternative – Separate Class V Asset

As a conceptual matter, an indemnity from Seller to Acquiror could be viewed as a separate Class V asset sold by Seller to Acquiror, like a note, to which part of the purchase price would be allocated. Under this analysis, gain or loss would be recognized to Acquiror based on the difference between the value of that Class V asset and the amount actually received. There is no authority supporting this analysis of indemnities.

V. Contingent Liabilities in Taxable Stock Acquisition Without Section 338(h)(10) or Section 336(e) Election

A. Contingent Liabilities in General

If Acquiror buys Target stock without a section 338(h)(10) or section 336(e) election, Target's treatment of its liabilities ordinarily does not change. Target continues to deduct or capitalize its accruals and expenditures without regard to the acquisition.

B. Income and Deductions

1. Taxable Year of Deduction

A sale of Target stock may itself generate or accelerate an obligation by Target to pay a contingent obligation—due to the terms of either pre-existing obligations or the sale agreement itself. Common examples are payments of employee stock options, stock bonuses or severance pay (vested or non-vested).

a. Consolidated Return

If Seller sells the Target stock in the middle of its consolidated year, Reg. § 1.1502-76(b) may determine which taxpayer gets the deduction and when.

- If the "same-day" rule of Reg. § 1.1502-76(b)(1)(ii)(A)(i) applies, the deduction belongs in Seller's consolidated return for the year of the sale (*i.e.*, the deduction is claimed on the day of the sale but before the sale is effective).
- If the "next-day" rule of Reg. § 1.1502-76(b)(1)(ii)(B) applies, the deduction belongs in Target's first separate return, which could be Acquiror's consolidated return for the year of the sale (*i.e.*, the deduction is claimed on the day after the sale).
- In many situations, Seller and Acquiror may decide by agreement whether the "same-day" rule or the "next-day" rule applies to a particular deduction, so long as the allocation is reasonable and consistently applied. Reg. § 1.1502-76(b)(1)(ii)(B). But there are limitations on this flexibility, as illustrated by GLAM 2012-010 (Nov. 15, 2012). Reg. § 1.1502-76, "relating to when a member joins or leaves a consolidated group," is the subject of an open guidance project. Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Consolidated Returns ¶ 4. In view of the controversy that met GLAM 2012-010, the "same day" and "next day" rules presumably are involved in this project.
- If a "ratable allocation" under Reg. § 1.1502-76(b)(2)(ii)(A) is available and is made, the deduction belongs partly in each return. A payment on an employee stock option, and the like, as a result of an acquisition, is an "extraordinary item," and ratable allocation is not available. Reg. §§ 1.1502-76(b)(2)(ii)(A) and 1.1502-76(b)(2)(ii)(C)(9).

b. Section 404(a)(5)

If Target pays "deferred compensation" subject to section 404(a)(5) (discussed in part IV.D.3., above) or transfers "property" in connection with the performance of services, subject to section 83(h), Target may claim the deduction only for the year in which the recipient is taxed. If the Seller group and the recipient are both on the calendar year, and the Target stock is sold in mid-year, the deduction can be claimed only in Target's first separate return, which could be Acquiror's consolidated return for the year of the sale.

2. Consolidated Return Anti-Churn-and-Burn Rule

The deduction of contingent obligations by Target in its final consolidated return year with Seller (*see* discussion of Reg. § 1.1502-76(b) in part V.B.1.a., above) could invoke the loss limitation in Reg. § 1.1502-11(b). If Seller and Target file consolidated returns, and Seller sells the Target stock, any loss incurred by Target in the year of the sale can be used to offset gain from sale of Target stock only within a limitation. The limitation is intended to protect taxpayers by preventing $1 of Target's net operating loss from generating a cycle of reductions in the basis of the Target stock that would eliminate all stock basis.

Example. Seller and Target are the only group members. Seller's basis in the Target stock is $100. In a single year, Seller breaks even; Target incurs a $100 loss; and Seller sells the Target stock for $101. But for Reg. § 1.1502-11(b), $1 of Target's loss would offset the $1 gain on the stock sale, but Target's $1 loss would reduce Seller's basis in the Target stock by $1 and generate another $1 of gain. Another $1 of Target's loss would be used to offset this gain, and the cycle would repeat until all of Target's $100 loss was absorbed with no tax benefit to the group.

To prevent this "churn-and-burn," Reg. § 1.1502-11(b) provides that Target's loss is used to the extent it absorbs group income or gain other than gain on the sale of Target stock. The unused loss is carried back or forward.

3. Income and Deductions from Assumed Stock Options and Restricted Stock

In Rev. Rul. 2003-98, 2003-2 CB 378, Target granted nonqualified stock options to employees. Later, Acquiror bought the Target stock and granted Acquiror stock options to the employees, who surrendered their Target options. IRS ruled that the employees recognized compensation income when they exercised their Acquiror stock options or cashed them out, and not before, and that Target, not Acquiror, is entitled to the offsetting deduction.

4. Prepaid Income

Under tax accounting rules, Target could have deferred tax on prepaid income (*see*, *e.g.*, § 455; Reg. §1.451-5; and Rev. Proc. 2004-34, 2004-1 CB 991). In an asset sale, the deferral usually terminates. *See* parts IV.E.1. and 2., above. A stock sale, however, ordinarily would not affect the deferral, and it would continue. Thus, the price for stock should reflect, not only the Target's contingent liability to provide the goods and/or services for which prepayment was made, but also the cost of the deferred tax the deferred tax becomes due (usually when the goods and/or services are provided). *See* W. Potter, "Approaching Deferred Revenue in Corporate Stock Acquisitions," 144 Tax Notes 1071 (Sept. 2014).

C. Contingent Liabilities as Built-in Loss

1. Section 382(h)

Contingent liabilities may be unrealized built-in losses under section 382(h)(6)(B). If so, and if Target 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. The legislative history of section 382(h) states:

> [A]ny item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Such items [of income] would include accounts receivable of a cash basis taxpayer that arose before the change date and are collected after that date, the gain on completion of a long term contract performed by a taxpayer using the completed contract method of accounting that is attributable to periods before the change date, and the recognition of income attributable to periods before the change date pursuant to section 481 adjustments, for example, where the loss corporation was required to change to the accrual method of accounting pursuant to Code section 448. Also, any amount which is allowable as a deduction during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction.

H.R. Rep. No. 100-795 at 46 (1996) (emphasis added). The examples of what is attributable to periods before the change date are very narrow. Thus, it is uncertain if any contingent liabilities will be treated as built-in losses. In Notice 2003-65, 2003-2 CB 747, IRS requested comments as to how built-in loss items should be determined for this purpose.

2. Consolidated Return Loss Matters

If Seller or Acquiror files consolidated returns, other issues arise.

a. Negative Investment Adjustments to Acquiror's Target Stock for Accrual and Payment of Contingent Liabilities

If the liabilities result in deductions when fixed or paid (current deductions, depreciation or amortization or indirectly, through capitalization and resulting increased basis recovery on a sale of assets), Acquiror's basis in the Target stock is reduced under the investment adjustment rules. Reg. § 1.1502-32.

b. Separate Return Limitation Year Rules Applied to Target

If the contingent liability is a built-in loss item under section 382(h) (discussed in part V.C.1., above), it may also be subject to a separate return limitation year (SRLY) limitation. The regulations generally prevent section 382 and the SRLY limitation from applying to the same loss if a SRLY event and a section 382 ownership change occur at the same time or within six months of each other. Reg. § 1.1502-15(g).

c. Prior Invalidated Loss Disallowance Rule Applied to Seller

A contingent liability reduces the value of the Target stock purchased by Acquiror but not Target's basis in its assets. On the other hand, such a liability did not count as a Target "liability" under the original consolidated return loss disallowance rule. Former Reg. § 1.1502-20(c)(2)(vi). Thus, the contingent liability could have resulted in a "duplicated loss." If Acquiror subsequently sold the Target stock at a loss, the loss would have been disallowed, even though the contingent liability was previously reflected in Acquiror's purchase price. This loss disallowance rule was declared invalid in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), *rev'g* 85 AFTR 2d 2000-1439 (Ct. Fed. Cl. 2000).

d. Interim Loss Disallowance and Anti-Loss Duplication Regulations Applied to Seller

In response to the Rite Aid decision, IRS announced, in Notice 2002-11, 2002-1 CB 608, that it would not litigate the validity of the duplicated loss rule. Shortly thereafter, IRS and Treasury suspended the entire loss disallowance rule (Reg. § 1.1502-20T(i)) and issued new temporary regulations (Reg. § 1.337(d)-2T) to address "noneconomic" stock losses. These temporary regulations were adopted in final form without substantial modification. TD 9187, 70 Fed. Reg. 10319 (Mar. 3, 2005). In general, Reg. § 1.337(d)-2 disallowed a loss on the Target stock unless the selling group could establish that the loss was not attributable to increases in the basis of Target stock (under Reg. § 1.1502-32) resulting from Target's recognition of gains that were "built-in" at the time Target became a member of the group (*i.e.*, a tracing regime). *See also* Notice 2004-58, 2004-2 CB 520 (providing alternative approaches to determining whether loss is attributable to built-in gains). In general, if Seller recognized a loss on a sale of Target stock, and the loss resulted from Target's contingent liabilities that could accrue after the sale, the loss was not disallowed under Reg. § 1.337-2. The reason was that the loss was not attributable to increases in the basis of Target's stock resulting from Target's recognition of built-in gains.

In addition, on March 23, 2003, Treasury promulgated Reg. § 1.1502-35T as an interim measure to address "loss duplication" in consolidated groups (*i.e.*, recognition by the group of more than one tax loss arising from a single economic loss). Those temporary regulations were adopted in final form without substantial modification. Reg. § 1.1502-35. TD 9254, 71 Fed. Reg. 13008 (Mar. 14, 2006). The anti-loss duplication regulations applied only to a disposition of a portion of Target's stock. They did not apply where, as is typically the case, Seller disposes of all the Target stock in one transaction. More fundamentally, the anti-loss duplication rule impacted only losses that were duplicated within a single consolidated group. They did not affect a loss on a sale of Target stock where Target, outside Seller's group, may benefit again from the loss through depreciation deductions or losses on asset sales.

In general, Reg. § 1.1502-35 had two prongs:

- If Seller owns Target shares with non-uniform basis and recognizes loss on a sale of some Target stock, the regulations reduced the loss to reduce the basis disparities.
- If Target remained a member of the Seller group after a sale of some Target stock, the Seller group's loss could be suspended until Target ceased to be a member of the group.

As noted above, the anti-loss duplication regulations did not address duplicated losses where the group disposed of all of its Target stock. Thus, where the group recognized loss on a sale of all its Target stock because Target had contingent liabilities, the regulations neither disallowed the loss on the sale of the Target stock nor prevented Target from deducting or capitalizing the payment of those contingent liabilities.

e. Final "Unified Loss Rule" Applied to Seller and Acquiror

(1) General

In 2007, Treasury proposed comprehensive regulations to replace Reg. §§ 1.337-2 and 1.1502-35. RIN 1545-BB61, 72 Fed. Reg. 2964 (Jan. 23, 2007). The final "unified loss rule," was adopted in 2008. Reg. § 1.1502-36. TD 9424, 73 Fed. Reg. 53934 (Sept. 17, 2008). It consists of three rules that apply sequentially when Seller transfers Target stock (including transfers of all the Target stock) at a loss.

(a) Basis Redetermination Rule

The first rule applies if Seller owns more than one block of Target stock, and the blocks have different basis. In such cases, the aggregate basis is reallocated to reduce disparities in basis among the blocks of stock. Reg. § 1.1502-36(b). As under the earlier Reg. 1.1502-35, the basis redetermination rule does not apply to a sale of all the Target stock in one transaction.

(b) Basis Reduction Rule

The second rule addresses noneconomic stock loss. It reduces Seller's basis in loss stock of Target (but not below its value) by the prior net positive § 1.1502-32 adjustments to the stock basis. The amount of the basis reduction is limited to the "disconformity amount"—the amount by which the basis of the Target stock exceeds Target's "net inside attribute amount" (the excess of the sum of the Target's money, asset basis, loss carryovers, and deferred deductions over non-contingent liabilities). Reg. § 1.1502-36(c).

(c) Attribute Reduction Rule

The third rule prevents duplication of a loss recognized on a sale of the Target stock, regardless of whether the duplication occurs inside or outside Seller's group. It does so by reducing Target's tax attributes after the stock sale. Reg. § 1.1502-36(d).

Target's attributes are reduced by the "attribute reduction amount," which is the lesser of (i) the excess of the Target stock basis (after application of the basis redetermination and basis reduction rules) over the value of the Target stock (the "net stock loss") or (ii) the excess of Target's net inside attribute amount (as defined in the basis reduction rule, described above, the excess of the sum of the Target's money, asset basis, loss carryforwards, and deferred deductions over its non-contingent liabilities) over the value of the Target stock (the "net inside loss").

Target's attributes are subject to reduction in the following order: (i) loss carryovers, (ii) deferred deductions and (iii) basis of assets other than cash (with special rules for lower-tier subsidiaries and marketable securities). In general, if the attribute reduction amount exceeds the attributes available for reduction, that excess attribute reduction amount has no further effect. *But see* part V.C.2.e.(2), below, discussing a special rule for contingent liabilities.

(2) Effect of Target's Contingent Liabilities

Target's contingent liabilities can cause Seller to recognize loss on the sale of the Target stock because the contingent liabilities reduce the value of the Target stock but do not reduce Seller's basis in the Target stock. Contingent liabilities can also result in a corresponding net inside loss, because contingent liabilities do not reduce Target's "inside attribute amount" discussed in part V.C.2.e.(1)(c), above. Thus, contingent liabilities may not require Target to reduce its attributes under the general attribute reduction rule.

For this reason, the attribute reduction rule contains a special rule that applies when Target has contingent liabilities. Reg. § 1.1502-36(d)(4)(ii)(C). As noted above, in general, if Target's "attribute reduction amount" exceeds the attributes available for reduction, the excess attribute reduction amount has no further effect. However, if the attribute reduction amount exceeds Target's attributes available for reduction, and if Target has contingent liabilities at the time of the stock sale, the excess attribute reduction amount is suspended and applied to prevent Target's later deduction or capitalization of payment of the contingent liability. This rule would apply, for example, if Target holds cash to pay a contingent liability. Because that cash is not subject to basis reduction, loss otherwise could be duplicated when Target's contingent liability is subsequently paid and a deduction or basis increase is claimed.

(3) Seller Election to Reduce Target Stock Basis in Lieu of Attribute Reduction

The attribute reduction rule allows the Seller group to elect to reduce its Target stock basis, reattribute Target's losses, or a combination of both, to prevent attribute reduction. Acquirors of stock of a Target that may be subject to attribute reduction should consider requiring Seller to make this election or to indemnify Acquiror against the effects of attribute reduction.

Example 1 Target has sufficient attributes; subsequent deduction for contingent liability allowed

Seller forms Target in Year 1 by contributing a parcel of land ("L1") to Target. The fair market value and basis of L1 are both $150. Thus, Seller's initial basis in the Target stock is $150. Target earns $100 in each of Years 1-5. Target retains the income. At the end of Year 5 Target purchases a second parcel of land ("L2") for $500. Thus, Seller's basis in the Target stock has increased to $650.

During Year 6, Seller sells the Target stock to Acquiror. L1 and L2 retain their value, but a potential environmental liability associated with L1 is discovered. Thus, Acquiror pays only $400 for the Target stock. At the time of the sale, Seller's basis in the Target stock is $650. Target's basis in L1 is $150 and its basis in L2 is $500. Target has no liabilities other than the contingent environmental liabilities.

Prior to the application of Reg. § 1.1502-36, Seller would recognize $250 loss on the sale of the Target stock. The sale would not be subject to the basis redetermination rule because Seller transfers all of its Target stock. Nor would the sale be subject to the basis reduction rule because, although Seller has increased its basis in the Target stock by $500, the disconformity amount is $0 (*i.e.*, Target's $650 stock basis is equal to Target's net inside asset amount ($150 basis in L1 plus $500 basis in L2 less $0 non-contingent liabilities)).

However, the sale would be subject to the attribute reduction rule. Target's attribute reduction amount is the lesser of the net stock loss ($650 - $400 = $250) or Target's aggregate inside loss (also $250, the excess of Target's net inside attribute amount ($650 asset basis) less the $400 value of the Target stock). Thus, Target's attribute reduction amount is $250. Target would reduce its basis in L1 and L2 proportionately by that amount. Target's basis in L1 would be reduced by $58 ($150/$650 × $250) to $92 ($150 - $58), and Target's basis in L2 would be reduced by $192 ($500/$650 × $250) to $308 ($500 - $192).

Because Target has reduced its attributes by the full attribute reduction amount, it can fully deduct or capitalize the later payment of its contingent environmental liability.

Alternatively, Seller may elect to reduce its basis in the Target stock (or reattribute any Target loss carryovers, none in this example). Thus, the value of the stock loss deduction relative to the lost value of Target's asset basis must be considered. For instance, if Seller does not anticipate that it will recognize capital gains against which the loss on the Target stock could be offset, Seller may agree to elect to reduce its stock basis in exchange for a higher purchase price reflecting the unreduced value of Target's asset basis. On the other hand, if Acquiror does not anticipate causing Target to sell L1 or L2 or otherwise recover its basis in L1 or L2, Acquiror may agree to accept the basis reduction and allow Seller to deduct the capital loss on the sale of the Target stock.

Example 2 Target has insufficient attributes; subsequent deduction for contingent liabilities partially disallowed

The facts are the same as in Example 1, except that Target does not buy L2 but instead retains the $500 cash earned in Years 1-5. At the time of the sale of the Target stock to Acquiror for $400, Seller's basis in the Target stock is $650; Target's basis in L1 is $150; and its basis in the cash is $500. Target has no liabilities other than the contingent environmental liability.

The sale would be subject to the attribute reduction rule. Target's attribute reduction amount is $250, as in Example 1. The only attribute available for reduction, however, is Target's $150 basis in L1, which would be reduced to $0. Target's cash is not subject to basis reduction.

Under the general rule, the remaining $100 of attribute reduction amount would have no further effect. However, because Target has contingent liabilities, the remaining $100 is suspended and reduces any amounts that Target otherwise would deduct or capitalize when it pays the environmental liability. For instance, if Target later pays an environmental liability of $250, the first $100 would not be deducted or capitalized, but the remaining $150 would be deducted or capitalized.

As in Example 1, Seller may elect to reduce its basis in the Target stock. Thus, the value of the capital loss on the stock sale relative to the lost value of Target's asset basis and the deduction or capitalization of the contingent liability must be considered. As in Example 1, if Seller does not anticipate that it will recognize capital gains against which the loss on the Target stock could be offset, Seller may agree to elect to reduce its stock basis in exchange for a higher purchase price reflecting the unreduced value of Target's asset basis and the deductions. Where, as here, there are insufficient attributes, other variables include the likelihood of Target paying and deducting the contingent liability and the timing of such payments and deductions.

D. Indemnity by Seller for Target's Contingent Liabilities

1. Treatment of Seller

Under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952), if, in connection with a sale of Target stock, Seller indemnifies Acquiror for a contingent liability of Target by making the indemnity payment to Acquiror, the indemnity is treated as a reduction in the sale price for the stock. *Central Gas & Electric Co. v. United States*, 159 F. Supp. 353 (Ct. Cl. 1958); *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976), *aff'd on other grounds*, 558 F.2d 128 (2d Cir. 1977); Rev. Rul. 58-374, 1958-2 CB 396; *Clay v. Commissioner*, T.C. Memo. 1981-375; *Nelson v. Commissioner*, T.C. Memo 1971-327; PLR 9842008 (Oct. 16, 1998); FSA 200147013 (July 10, 2001); FSA 199942025 (Oct. 22, 1999).

If Seller indemnifies a contingent liability of Target by making payment to Target, the indemnity payment is treated as a contribution to Target's capital by Seller, relating back to immediately before the stock sale. The payment thereby increases Seller's basis in the Target stock. Rev. Rul. 83-73, 1983-1 CB 84; GCM 38977 (Apr. 8, 1982).

The consequences to Seller should be the same regardless of whether the indemnity payment is made to Acquiror and treated as a reduction in sale price or is made to Target and is treated as a contribution to capital. In either case, Seller is entitled to a capital loss, rather than an ordinary deduction at the time the indemnity is paid or becomes fixed. This capital loss may be deductible, or it may be disallowed under the consolidated return loss disallowance regulations. *See* parts V.C.2.c. through e. above.

Any interest accruing on the contingent liability after the sale also relates back to the time of the sale and is treated as a return of purchase price rather than as deductible interest expense to the indemnitor. Rev. Rul. 58-374, 1958-2 CB 396 (portion of indemnity payment representing interest accruing after stock sale on tax liability incurred by Target before sale treated as relating back to stock sale). *See also Leward Cotton Mills v. Commissioner*, 245 F.2d 314 (4th Cir. 1957).

2. Treatment of Acquiror and Target

a. Indemnity of Target Liability Paid by Seller to Target

Neither Target nor Acquiror is required to include the indemnity payment in income. Rev. Rul. 83-73, 1983-1 CB 84; GCM 38977 (Apr. 8, 1982). However, whether Seller makes the indemnity payment to Target or Acquiror may affect Target's ability to deduct the indemnified liability. Where the indemnity is paid to Target and treated as a capital contribution by Seller prior to the sale, Target should be treated as paying the liability itself and may be entitled to a deduction or asset basis increase. *Central Elec. & Gas Co. v. United States*, 159 F. Supp. 353 (Ct. Cl. 1958); *Leward Cotton Mills v. Commissioner*, 245 F.2d 314 (4th Cir. 1957); FSA 199942025 (July 27, 1999). The best facts would be where Seller owes and pays the indemnity to Target, rather than Acquiror, and Target pays the underlying liability. These niceties may not need to be observed, however, and Target may be entitled to a deduction even if Seller pays the liabilities directly. *Central Elec. & Gas Co.*

It is unclear whether Target may take a deduction where the indemnity payment is paid to Acquiror and treated as a reduction in the purchase price for the stock. Arguably, Seller could be deemed to make the indemnity payment to Acquiror, and Acquiror could be deemed to contribute the indemnity payment to Target. These deemed cash flows would be consistent with Target paying the liability and taking a deduction.

Addressing the overarching tax benefit issue, the Court of Claims and IRS have concluded that, where Target is otherwise entitled to a deduction for an expense, Target is not prohibited from claiming the deduction merely because the expense is indemnified. 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 allowed the deduction, and IRS has agreed. Rev. Rul. 83-73, 1983-1 CB 84. *See* part X.C.2.a., below. In GCM 38977 (Apr. 8, 1982), IRS concluded that the treatment for reorganizations would also apply to taxable stock purchases, and this view has been followed in private rulings and field service advice. PLR 8429014 (Apr. 16, 1984); PLR 9029058 (Apr. 25, 1990); FSA 200147013 (July 10, 2001).

b. Reimbursement of Tax Benefit

If Acquiror reimburses Seller for the tax benefit received from Target's deducting indemnified expenses, the reimbursement increases Seller's amount realized on the stock sale and Acquiror's basis in the Target stock. PLR 8429014 (Apr. 16, 1984) (payments by Seller to Target's medical claims administrator after stock sale ruled capital contributions, not income to Target, and deductible to Target; payments by Acquiror to Seller for tax benefit of medical payments ruled adjustments to purchase price for Target stock); FSA 199942025 (Oct. 22, 1999).

c. Settlement on Indemnity Obligation

Suppose Seller agrees to indemnify Acquiror for a Target contingent liability, and later Seller makes a payment to Acquiror to settle its obligation. Suppose also that, ultimately, Target's liability does not have to be paid at all, or that the amount paid by Target is less than Seller's settlement payment. Should Seller's payment still be treated as a capital contribution by Acquiror to Target relating back to the sale (with, presumably, a deemed section 301 distribution by Target to Acquiror)? Or is there a reduction in purchase price of the Target stock? In either case, there should be no taxable income to Target or Acquiror.

E. Other Indemnities or Compensation Payments Between the Parties

Seller may indemnify or compensate Acquiror for other risks—not just Target's liabilities. The treatment of these payments may depend on whether they are made as part of the original transaction or as a result of a new arrangement.

1. Payments as Part of the Original Transaction

In *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo 1977-429, a broker agreed to indemnify Acquiror for its inability to sell a Target asset unwanted by Acquiror. In an *Arrowsmith*-like analysis, the court treated the indemnity payment as a reduction in Acquiror's purchase price for the Target stock. The fact that a third party made the payment to Acquiror meant that Seller's treatment was not affected, but Acquiror's basis in the Target stock was reduced. There was no taxable income to Acquiror or Target.

In *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976), *aff'd on other grounds*, 558 F.2d 128 (2d Cir. 1977), Seller effectively guaranteed a projected level of earnings from one of Target's assets via an indemnity. The earnings fell short of the guaranteed level, and Seller paid the indemnity. Citing *Arrowsmith*, the Tax Court treated Seller's indemnity payments as adjustments to sale price and therefore capital losses.

For examples of indemnity payments not treated as relating back to a sale, *see Inland Asphalt Co. v. Commissioner*, 756 F.2d 1425 (9th Cir. 1985) (indemnity payment related to a previous distribution-leaseback transaction between Target and Seller rather than to sale); TAM 200427023 (July 2, 2004)) (Target whose stock was sold received indemnity payment from Seller's assignee for breach of contractual obligations assumed by assignee; payment taxed as ordinary income; *Arrowsmith* not applied).

2. Payments as Part of New Transaction

In PLR 200518014 (Dec. 30, 2004), C, a consolidated group parent, sold the stock of two subsidiaries (X and Y) to B, the parent of another consolidated group. The sale agreement provided that, if X or Y incurred a net operating loss ("NOL") after the Closing, the NOL would not be carried back to a C year. After Closing, the law was changed to allow NOL carrybacks for five years instead of two years. In the fourth year after Closing, X and Y incurred NOLs. C and B reached a new agreement that the NOLs would be carried back to a C year, that C would file the refund claims, and that C would retain $^1/_3$ of the refund and pay the remaining $^2/_3$ to B. IRS ruled that the payment by C to B was not a return of purchase price under *Arrowsmith*, because it was not made pursuant to the original agreement, but that, instead, the payment was ordinary income to B and deductible to C. Presumably, C retained $^1/_3$ of the refund tax-free. This ruling was sharply criticized for disregarding the regulations on allocating tax liabilities among members of consolidated groups and so suggesting that C could retain the refund tax-free. J. Prusiecki, "Brilliant Advocacy or Very Good Luck?" 107 Tax Notes 1751 (June 27, 2005). The ruling was revoked retroactively without substantive explanation, except for the statement that it "is not in accord with the views of the Service." PLR 200613022 (Oct. 28, 2005).

VI. Contingent and Escrowed Stock in General

A. Background and General Treatment

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, but the courts rejected this argument. In response, IRS first adopted a policy of issuing advance rulings on tax-free reorganizations involving contingent stock but only if the right to receive the contingent stock was not separately transferable. Rev. Rul. 57-586, CB 1957-2, 249; Rev. Rul. 66-112, 1966-1 CB 68; Rev. Rul. 67-90, 1967-1 CB 79.

In view of these authorities, Target shareholders may receive contingent and escrowed stock tax-free under section 354 if guidelines are observed. It should also be noted that the receipt of contingent and escrowed stock is not subject to tax under section 305(b), because the contingent or escrowed stock is not issued "with respect to stock" of the issuer. J.P. Holden, "Unraveling the Mysteries of Section 305," 36th Ann. N.Y.U. Inst. Fed Tax'n 781, 813 (1978).

B. Advance Ruling Guidelines

Ultimately, IRS developed advance ruling guidelines for contingent and escrowed stock in Rev. Proc. 77-37, 1977-2 CB 568, and then revised them in Rev. Proc. 84-42, 1984-1 CB 521. The tests relate to the following factors:

- Business purpose for the arrangement (usually that the parties cannot agree on price).
- Time limit of five years until all stock is returned or issued.
- No more than 50% of all the stock issued may be contingent or escrowed stock.
- Rights to contingent stock not assignable, or at least not negotiable or readily marketable.
- Only additional stock may be issued, not other property.
- Contingencies are subject to objective determination; contingencies are not in the control of either or both of the parties or contingencies relating to death, continued employment of a shareholder or Target's tax liability.
- Any escrowed stock is issued and outstanding, and Target 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 both qualify for tax-free treatment and count favorably toward the continuity-of-interest test, the "solely for voting stock" test for type-B reorganizations and the "control for voting stock" test for reverse triangular mergers. An example of a private ruling using these tests is PLR 9827027 (Apr. 3, 1998). For a discussion of the case law and these tests, *see* R. Willens, "Contingent Stock Acquisitions Should Gain Popularity in Uncertain Times," Daily Tax Report June 23, 2003.

C. Commentary and No Rule

Some commentators have argued that the advance ruling guidelines are more restrictive than the case law. D. Tillinghast, "Contingent Stock Pay-Outs in Tax-Free Reorganizations," 22 Tax Law.

467 (1969); R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981); J.C. Fleming, "Rethinking Contingent Price Reorganizations," 9 J. Corp. Tax'n 3 (1982). Nevertheless, the prior advance ruling guidelines have become the usual standards in structuring transactions.

In Rev. Proc. 2014-3, 2014-1 IRB 111, IRS has announced that it will no longer issue advance rulings on tax-free reorganizations as a whole but only on "significant issues presented" therein. It is not clear whether contingent stock or escrowed stock would result in a significant issue so that a ruling could be obtained on those matters.

D. Contingent Stock and Escrowed Stock and the Continuity-of-Interest Signing-Date Fixed Consideration Rule

1. Background

To satisfy the continuity-of-interest requirement for a tax-free reorganization, at least 40% of the consideration received for the Target stock must consist of stock of Acquiror or in some instances Acquiror's parent corporation. Reg. § 1.368-1(e)(2)(v) Example (1). Generally, consideration is valued for this purpose when paid, usually at Closing. A long-standing and common problem concerns the situation in which Target and Acquiror agree on pricing terms by contract, but the Closing and payment of consideration take place later. If the value of the Acquiror stock declines before in the interim, continuity of interest may be jeopardized.

2. 2004 Proposed Regulations and 2005 Final Regulations

In August 2004, regulations were proposed to eliminate this problem by allowing the value of the Acquiror stock to be fixed as of the day before a binding contract is entered into. Prop. Reg. § 1.368-1(e)(2). This rule would have applied only in limited circumstances. If consideration was escrowed, the rule would have applied, but only if the escrow was "to secure customary target representations and warranties." The rule would not have applied if any contingent consideration was involved, even if all stock.

In 2005, IRS and Treasury adopted final regulations based on the proposed regulations but responding to numerous comments from the tax bar. TD 9225 (Sept. 15, 2005). Like the proposed regulations, the final regulations did not deal with post-Closing contingent consideration—as acknowledged in the preamble.

3. 2007 Temporary Regulations

On March 19, 2007, IRS and Treasury adopted a new set of proposed and temporary regulations on this subject. TD 9316, 72 Fed. Reg. 12974 (Mar. 20, 2007). In response to comments, the proposed and temporary regulations allowed the value of the Acquiror stock to be fixed as of the day before the binding contract for continuity purposes, even if there is contingent consideration, if (a) the transaction would satisfy the continuity test without the contingent consideration, and (b) the contingent consideration does not prevent the exchanging Target shareholders from being subject to the economic benefits and burdens of owning Acquiror stock. In 2007, the temporary regulations expired, but, in Notice 2010-25, 2010-1 CB 527, IRS announced that, until issuance of final regulations, taxpayers could choose to follow the proposed regulations that mirrored the temporary regulations, subject only to a consistency requirement.

The tax bar had mixed response to these proposed temporary regulations. Among other comments, some stated that the signing date rule should be broadened to include contingent stock and "collar" arrangements, and other situations. Amer. Bar. Ass'n Section of Tax'n, "Comments on Temporary and Proposed Regulations Regarding the Measurement of Continuity of Interest Under Section 368" (Feb. 26, 2010).

4. 2011 Final Regulations

On December 16, 2011, final regulations similar to the 2007 proposed and temporary regulations were adopted. TD 9565, 72 Fed. Reg. 12974 (March 20, 2007). Reg. §§ 1.368-1(e)(2)(iii)(B), 1.368-1(e)(2)(v) Examples (10), (11), (12). Under the final regulations, if the contingency to which the consideration is subject relates to the value of the Acquiror stock (*e.g.*, a collar), then, the signing date rule does not apply, and the value of the Acquiror stock is measured at the time of Closing.

The final regulations do not address issuances of contingent consideration after Closing. Apparently, if the contingent stock is treated as "stock" (*see* part VI.A., above), the continuity test is applied again taking this consideration into account, but, if the signing-date tests are met, the value of the Acquiror stock is measured as of the day before the contract is entered into. Otherwise, the value of the Acquiror stock may be measured as of when it is issued.

The rule on escrowed consideration is similar to the rule in the proposed regulations. If consideration is escrowed, the signing date valuation rule can apply, provided the escrow is "to secure target's performance of customary pre-Closing covenants or customary pre-Closing target representations or warranties." Otherwise, the contingent consideration rules apparently apply, but, again, the regulations are not explicit on this point. The final regulations contain an example suggesting that escrowed stock that is ultimately forfeited and returned to Acquiror does not count favorably toward continuity. Treas. Reg. § 1.368-1(e)(2)(v) Example 2. *See* part VII.C.4., below.

5. 2011 Proposed Regulations

On the same day as the issuance of the 2011 final regulations, IRS and Treasury published proposed regulations to provide new methods to value stock for continuity-of-interest purposes. Prop. Reg. §§ 1.368-1(e)(2)(vi) and (vii). The proposed regulations would allow use of average traded prices of the stock during periods after the signing of a binding contract and before Closing. They would also allow use of floor and ceiling prices and collars. None of the proposed regulations, however, relates to post-Closing events.

VII. Escrowed Stock

A. Escrowed Stock as Stock for Reorganization Purposes

Most practitioners observe the convention that, if escrowed stock satisfies the former advance ruling tests in Rev. Proc. 84-42, it is treated as "stock" that qualifies for tax-free treatment. *See* part VI.B., above.

B. Treatment at Closing

1. General

In a reorganization, escrowed stock is treated as though Acquiror had issued the stock to the Target shareholders, who then transferred the stock to the escrow. At least that is what IRS contemplates in Rev. Proc. 84-42. The Target shareholders are to vote the stock. Dividends are "to be distributed" and taxed to the Target shareholders. (Can the dividends themselves be escrowed?) This treatment is not consistent with the treatment of escrows in taxable acquisitions, as reflected in Prop. Reg. § 1.468B-8. *See* parts III.B. and III.C., above. These proposed regulations, however, would not apply to tax-free acquisitions. Prop. Reg. § 1.468B-8(b)(1).

2. Stock Basis

Because escrowed stock is considered to belong to the Target shareholders, the stock is part of the consideration for the Target stock, and the escrowed shares are allocated part of the overall substituted basis under section 358(a) and Reg. § 1.358-2(a).

3. No Imputed Interest

There is no imputed interest on escrowed stock. Rev. Rul. 70-120, 1970-1 CB 124. Compare part VIII.D., below, discussing imputed interest on contingent stock.

4. Effect on Continuity of Interest

See part VI., above.

C. Effect of Return of Escrowed Stock to Acquiror

1. Possible Analyses

If escrowed stock is returned to Acquiror, *e.g.*, because of indemnity obligations, there may be either (a) a reduction to the consideration for the Target stock (as in a taxable acquisition) or (b) a separate redemption of the stock by Acquiror, 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 a reduction to the consideration for the Target stock, if the returned stock is valued, for purposes of the transaction, based on its value at the time of the original acquisition. Rev. Rul. 76-42, 1976-1 CB 102; Rev. Rul. 76-334, 1976-2 CB 108.

In this case, there is no gain or loss realization to the former Target shareholders. The holders' remaining shares take on the part of the substituted basis that had been allocated to the escrowed shares. Reg. § 1.358-2(a) provides rules for allocating the basis of shares of Target stock surrendered in the transaction among the Acquiror shares received. In general, the parties may agree on this allocation among blocks of Target stock and different classes of stock and follow this agreement, so long as the allocation is economically reasonable. A complete revision of these regulations has been proposed to reduce this flexibility. Neither the current regulations nor the proposed regulations address how the added basis from the return of escrowed stock to Acquiror is allocated among the holders' shares. Nevertheless, it would seem reasonable to follow the methodology of these regulations in such a situation.

If any of a holder's other shares of Acquiror stock have been sold in the meantime, gain or loss presumably is recognized under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), to account for the basis adjustment.

3. Changes in Stock Value Taken into Account

If the formula for the number of shares returned takes into account changes in Acquiror stock value after Closing, the return of the escrowed stock is treated as a separate redemption of Acquiror stock. The redemption price is the value of the escrowed stock that is redeemed. Rev. Rul. 78-376, 1978-2 CB 149. According to this ruling, the same amount is added to the redeemed shareholders' basis in their remaining Acquiror stock. Query whether the indemnity amount should be added to the shareholders' basis in all the Acquiror stock received in the original transaction (including the escrowed stock redeemed). If the redemption is treated as a sale under section 302(a), then the redeemed 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), then, under Reg. § 1.302-2(c), the basis of the redeemed stock generally shifts to the other Acquiror stock held by the shareholder.

4. Effect of Return of Escrowed Stock on Continuity of Interest

Under the general continuity-of-interest regulations, Acquiror stock issued in a potential reorganization and then redeemed by Acquiror, "in connection with" the purported reorganization, counts against continuity. Reg. § 1.368-1(e)(1)(i). Does this rule apply to escrowed stock that is returned to Acquiror pursuant to the terms of the transaction?

In Rev. Rul. 76-334, 1976-2 CB 108, after a type-B reorganization, escrowed stock was returned for cash equal to half the stock value in settlement of claims and on terms that differed from those of the transaction agreement. IRS ruled that the cash was received in a separate redemption and did not prevent the transaction from qualifying as a type-B reorganization.

On the other hand, Reg. § 1.368-1(e)(2)(v) Example 2 states that escrowed stock that is forfeited and returned to Acquiror pursuant to the terms of the transaction does not count favorably toward continuity-of-interest. Such a situation should not, however, have further adverse impact on continuity, because the Target shareholder whose stock is returned to Acquiror does not receive cash or other consideration that counts against continuity.

VIII. Contingent Stock

A. Contingent Stock as Stock – Continuity of Interest

As with escrowed stock, most practitioners observe the convention that, if contingent stock satisfies the former advance ruling tests in Rev. Proc. 84-42, it is treated as stock qualifying for tax-free treatment. *See* part VI.B., above. The value of the fixed and contingent stock may be measured on the day before a binding contract is entered into. *See* part VI.D., above.

B. Treatment at Closing

The regimes for contingent stock and escrowed stock are different. Contingent stock is treated as issued only when the contingency disappears and the stock is actually issued. Basis is reallocated among all the shares issued in the reorganization.

C. Second Acquisition

IRS has ruled that, after an acquisition involving contingent stock (the "first acquisition"), a second acquisition of Acquiror corporation would not adversely affect the tax-free treatment of the contingent stock in the first acquisition, even though stock of the second Acquiror corporation was issued instead of the contingent stock intended to be issued in the first acquisition. Rev. Rul. 75-456, 1975-2 CB 128; PLR 9838007 (June 16, 1998).

D. Treatment of Receipt by Former Target Shareholders – Imputed Interest

1. Imputed Interest

Imputed interest is another feature of contingent stock but not escrowed stock. The courts and IRS have long been consistent in concluding that the deferred issuance of contingent stock is a deferred payment under section 483 and includes imputed interest. *Tribune Publishing Co. v. United States*, 836 F.2d 1176 (9th Cir. 1987); *Kingsley v. Commissioner*, 662 F.2d 539 (9th Cir. 1981); *Vorbleski v. Commissioner*, 589 F.2d 123 (3d Cir. 1978); *Katkin v. Commissioner*, 570 F.2d 139 (6th Cir. 1978); Fox v. United States, 510 F.2d 1330 (1974); *Jeffers v. United States*, 556 F.2d 986 (Ct. Cl. 1977); *Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga. 1980); *Cocker v. Commissioner*, 68 T.C. 544 (1977); *Catterall v. Commissioner*, 68 T.C. 413 (1977); *Solomon v. Commissioner*, 67 T.C. 379 (1976); Rev. Rul. 72-35, 1972-1 CB 139; Rev. Rul. 70-300, 1970-1 CB 125, *clarified*, Rev. Rul. 72-32, 1972-1 CB 48; Rev. Rul. 73-298, 1973-2 CB 173.

2. Interest Income to Target Shareholders as Received

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

3. Deduction to Acquiror

Section 163(l), enacted in 1997, provides that a borrower may not deduct interest payable in stock. Notwithstanding the broad statutory language, there is good reason to believe that section 163(l) does not apply to contingent stock issued in a reorganization.

- A contingent stock obligation may not be a "debt instrument" within the meaning of section 163(l). Reg. § 1.483-4(b) Example 2, states that a contingent stock obligation is "not a debt instrument for federal income tax purposes," so that there is no original issue discount under section 1274, but instead interest is imputed on the cash method under section 483.
- In a private ruling, IRS declined to apply section 163(l) where a debt would be paid in stock only in certain unlikely events. PLR 200052027 (Sept. 29, 2000).
- In Rev. Rul. 2002-31, 2002-1 CB 1023, IRS ruled that the issuer of convertible debt with contingent interest—based on the value of the issuer's stock—may deduct original issue discount-type interest on the "noncontingent bond method" of Reg. § 1.1275-4(b). It also holds that the interest is deductible, in spite of section 163(l).

4. Disadvantage of Escrowed Stock

As discussed in part VII.B.3., above, there is no imputed interest if escrowed stock is used instead of contingent stock. But escrowed stock may not be an option. For financial accounting purposes, escrowed stock may be treated as outstanding stock in computing earnings per share, whereas contingent stock is not treated as outstanding stock. FAS No. 128 (1997).

E. Treatment of Receipt of Contingent Stock by Former Target Shareholders – Effect on Basis of Acquiror Stock

If contingent stock is issued, the contingent shares received as imputed interest are taxable to the recipients, and they take full fair market value basis in these shares.

As to the remainder of the contingent shares, the former Target shareholders adjust their basis in their Acquiror stock to allocate an appropriate part of their substituted basis under section 358(a) to the contingent shares. The situation is a mirror image of the situation that exists when escrowed stock is returned to the issuer. *See* part VII.C.2., above. As in that situation, although there are no authorities directly on point, it would seem reasonable to follow the methodology of Reg. § 1.358-2(a) to reallocate stock basis to contingent stock. Also, if any of a holder's other shares of Acquiror stock have been sold in the meantime, gain or loss presumably is recognized under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), to account for the basis adjustment.

F. Effect of Non-Receipt by Former Target Shareholders

If the former Target shareholders do not receive the contingent stock, there is no effect on either Acquiror or the former Target shareholders.

G. Nonvested Compensatory Stock

1. Issue

In some industries, it is common for employee-stockholders of Target to receive, in exchange for their Target stock, Acquiring stock that is subject to restrictions, even though their Target stock is unrestricted. In such a situation, the question is how to reconcile the tax-free exchange treatment allowed under the reorganization rules with the taxation of compensatory stock under section 83.

2. Partial Solution

In Rev. Rul. 2007-49, 2007-2 CB 237, Situation 2, IRS reconciled these two sets of rules: A, a Target employee, owned 100 shares of Target stock with $1,000 basis and $31,000 value. In a reorganization, Acquiror acquired the Target stock in exchange for its own stock. A received Acquiror shares worth $31,000, subject to restrictions for three years: (a) if A's employment with Acquiror terminates, A must sell the shares back to Acquiror for $31,000 or its value at the time of forfeiture, whichever is less, and (b) in the meantime the shares are nontransferable. IRS ruled that A's exchange of Target stock for Acquiror stock was tax-free under the reorganization rules, and that, by making a section 83(b) election, A could lock in the value of the Acquiror stock it received at $31,000 and avoid taxable compensation income at any time—either at the time of the acquisition or later, when the forfeiture lapsed. If A did not make the section 83(b) election, however, he or she would be taxed on the value of the stock at that time, less $31,000.

Rev. Rul. 2007-49 focuses mainly on section 83. Thus, it does not say whether the nonvested stock that A receives counts favorably or unfavorably toward continuity-of-interest in general or deal with other continuity-of-interest issues, *e.g.*, whether fluctuations in the value of the Acquiror stock between the date the contract was signed and the Closing date would affect continuity-of-interest. *See* part VI.D., above.

In Rev. Rul. 2007-49, A was one of many Target shareholders and was the only service provider among them. Thus, A was the only Target shareholder to receive nonvested Acquiror stock. The other shareholders received the same stock consideration as A but without the restrictions. This situation, although not uncommon, is anomalous in that A was not treated the same as other holders of the same stock. Rev. Rul. 2007-49 disregards this anomaly. By so doing, it avoids an issue that arises if most or all of the shareholders are also employees and receive restricted stock. In this situation, it may be unclear how much of the Acquiror stock is received for the Target stock and how much for services, *i.e.*, the value of the Target stock. If the value of the Target stock is less than the value of the Acquiror stock received, the employee-shareholders will have taxable compensation income under section 83, even though the acquisition qualifies as a tax-free reorganization.

On its facts, Rev. Rul. 2007-49 also does not address the "signing-date" continuity-of-interest rules, discussed in part VI.D., above. If A's nonvested stock is forfeited only if employment terminates, however, the contingency would not seem to relate to the value of the stock, and so continuity-of-interest should be determined based on the value of the Acquiror stock when the acquisition contract is signed.

IX. Options to Acquire Stock

A. Treatment of Options as Zero-Principal Securities

Options to acquire stock (including warrants) received in tax-free reorganizations are treated as securities with zero principal amount. Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b). The effect of this treatment is to extend nonrecognition to the receipt of options in a reorganization. Section 356(a)(1)(B); Reg. § 1.356-3(c) Examples 7, 8, and 9 (illustrating the effect of a right to acquire stock having no principal amount). Nonrecognition treatment prevails if the Target shareholder exchanges (1) Target options or securities for Acquiror options or (2) Target stock for Acquiror options and Acquiror stock.

B. Treatment of Options as Boot in Certain Exchanges

Options received in a reorganization are treated as taxable boot if the Target shareholder exchanges Target stock for Acquiror options. Reg. § 1.354-1(d) Example 4; Sections 354(a)(2)(A), 355(a)(3) and 356(d). Acquiror's nonqualified preferred stock ("NQPS") or Acquiror's NQPS options received in exchange for anything other than Target NQPS or Target NQPS options are also taxed as boot. Reg. § 1.356-6(a). *See* TD 8882, 65 Fed. Reg. 31,078 (May 16, 2000). In these situations, Target shareholders recognize gain up to the fair market value of the options. Section 356(a)(1); Reg. § 1.356-1(a). The regulations provide no guidance on the valuation of options, but presumably principles analogous to the valuation of options in other contexts would apply. *See, e.g.*, Rev. Rul. 59-60, 1959-1 CB 237; Sections 83, 305 and 307(b)(1).

C. Effect on Continuity of Interest

The preamble to TD 8752 (adopting the final option regulations under sections 354, 355 and 356) does not discuss whether options count favorably or unfavorably toward continuity of interest. But the preamble to the proposed regulations cites *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942) (stock options not stock for continuity-of-interest purposes). 61 Fed. Reg. 67,508 (Dec. 23, 1996). TD 8752 adopted the proposed regulations in substantially the same form, and so it would appear that options count unfavorably toward continuity of interest, as non-stock consideration.

X. Target's Contingent Liabilities

A. "Assumption" of Liabilities

Section 357 governs much of the treatment of liabilities assumed in tax-free corporate acquisitions. As long as liabilities are not assumed for a tax avoidance purpose, (and, in some instances, as long as the amount of the assumed liabilities does not exceed the basis of the property transferred by the same transferor), the liabilities are not treated as taxable "boot."

B. Possible Effect of Assumption of Target's Contingent Liabilities on Tax-Free Reorganization Status

1. Identity of 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). So the parties must be careful in structuring a transaction to be sure that the correct corporation "assumes" the liability, within the meaning of section 357(d). Rev. Rul. 70-107, 1970-1 CB 78, Rev. Rul. 70-224, 1970-1 CB 79, and Rev. Rul. 73-257, 1973-2 CB 189 (in triangular acquisition, Parent may assume Target liabilities if acquisition is a merger, but not otherwise).

2. Cause-to-Direct Acquisitions

a. General

As stated in part X.B.1., above, IRS has taken the position that, in some reorganizations, Target liabilities may not be assumed directly from Target by a subsidiary of the acquiring corporation. In Rev. Rul. 64-73, 1964-1 CB 142, however, IRS allowed the acquiring corporation to cause Target assets to be transferred directly to a lower-tier subsidiary while being deemed transferred first to the acquiring corporation and then by the Acquiring corporation to its subsidiary. In structuring a transaction in which Target liabilities are transferred in this manner, caution is warranted, and careful documentation is necessary.

b. Disregarded Entities

It may be possible to avoid having a parent "acquiring corporation" assume the contingent liabilities of Target by having Target transfer its assets and liabilities to a limited liability company or similar entity that can be treated as a disregarded entity of the parent. Reg. § 301.7701-2(c)(2). Such a transaction could qualify as a type A or a type-C reorganization. Reg. § 1.368-2(b)(1) (merger of Target into disregarded entity of parent may qualify as type-A reorganization—merger of Target into parent).

3. Proposed Regulations on Transactions Involving the Transfer of Net Value

In March 2005, regulations were proposed to make clear that, for a transaction to qualify as a tax-free reorganization, there must be a transfer of "net value" by Target to Acquiror. Notice of Proposed Rulemaking, REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 FR 11903 (Mar. 10, 2005). In other words, the fair market value of the assets transferred must be greater than the liabilities assumed in the transaction. For this purpose, contingent liabilities are included in Target's liabilities. Thus, Target's contingent liabilities could prevent an acquisition from qualifying as a reorganization. But the method of determining the amount of liabilities is not specified. The preamble suggests several ways in which the amount of liabilities might be determined. These methods, include (a) the "value" of each liability (the amount a third party would have to be compensated to assume the liability) and (b) the maximum amount of the liability if there is a more-than 50% probability of payment (*see also Merkel v. Commissioner*, 192 F.3d 844 (9th Cir.1999) (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 he would be called upon to pay them; discounting of liability for this purpose by probability of occurrence rejected)), and (c) disregarding the excess of a nonrecourse liability over the fair market value of the property securing it.

C. Deductions to Acquiror and Related Matters

1. Acquisitive Reorganizations – Step-in-the-Shoes Treatment

The treatment of contingent liabilities in tax-free acquisitive reorganizations is codified in section 381(c)(16) and in the regulations. Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a). Generally, Acquiror steps into Target's shoes and may deduct liability items assumed from Target as though no acquisition had occurred. Nondeductible liability items assumed from Target do not become not 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 CB 61. If the liability was reflected in determining the amount of stock issued in the reorganization, the general rule in section 381(c)(4) applies, and Acquiror steps into Target's method of accounting. The results appear to be the same either way.

2. Acquisitive Reorganizations – Indemnities for Contingent Liabilities Paid by Acquiror

Target's contingent liabilities that are indemnified by former Target shareholders could be treated as never assumed or paid by Acquiror (especially if the indemnity involves return of stock issued in the reorganization). The case law supports treating the indemnity payment as a contribution to Target's capital by the former Target shareholders. As a result, a stepped-up basis is allowed to the indemnifying shareholder; a deduction is allowed to Acquiror; and there is no taxable gain or income to any party (except, of course, the person receiving the indemnity payment).

a. Treatment of Acquiror and Target

In *VCA Corp. v. United States*, 77-2 USTC ¶ 9736, 40 AFTR 2d ¶ 77-5429, *unpublished opinion*, 566 F.2d 1192 (Ct. Cl. 1977), the court allowed Acquiror to deduct certain Target expenses after a merger of Target into Acquiror, even though Acquiror was indemnified by the former Target shareholders. This seems to be the right answer. Acquiror, as Target's successor, ought to have the deduction, like the former partners in *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943). IRS has adopted the view of the *VCA* court. AOD 1981-115.

Acquiror realizes no taxable income from the reimbursement. Rev. Rul. 83-73, 1983-1 CB 84, clarifying Rev. Rul. 58-374, 1958-2 CB 396. GCM 38977 (Apr. 8, 1982) explains this result as following from the treatment of the indemnity payment as a contribution to Target's capital, occurring immediately before the merger.

b. Treatment of Former Target Shareholders

Treating the indemnity payment as a capital contribution means that the former Target shareholders are not entitled to deduct the indemnity payment. Instead, the payment is treated as an increase in the basis of their Target stock before the acquisition, and this increased basis is reflected in the basis in the Acquiror 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.

c. Combined Results

The combined results are akin to a double deduction: Target gets the ordinary deduction for the item, and the Target shareholders get stepped-up basis in the Acquiror stock as a result of a deemed contribution to Target's capital immediately before the reorganization.

3. Section 351 Exchanges – General

a. No Statutory Step-in-the-Shoes Treatment

Section 381 does not apply to transfers of assets or businesses under section 351. Without section 381, the corporate transferee could be subject to case law treating liability assumption as part of the cost of the property and so capitalized when paid (not deducted by the transferee and perhaps not by the transferor either). *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 no gain was recognized to the transferor (as would be the case for an assumed liability, unless section 357(b) or (c) applied), the transferee would get no asset basis for the payment either.

b. Rev. Rul. 95-74, 1995-2 CB 36

In Rev. Rul. 95-74, 1995-2 CB 36, IRS ruled that contingent environmental liabilities of a transferor assumed in a section 351 transfer of a business resulted in deductions to the transferee as the payments were made. IRS believes this ad hoc "step-in-the-shoes" favorable treatment is limited to situations where the assets transferred and the liabilities assumed involved a transfer of a full business, and there was a business purpose for the transfer.

4. Section 351 Exchanges – Scope and Meaning of Step-in-the-Shoes Treatment

a. General

In a section 351 exchange, when the transferee corporation assumes a contingent liability of the transferor and later pays the liability, there could be various tax impacts. Either the transferor or the transferee could be entitled to the deduction (or capital item). At the time the transferor pays the assumed contingent liability, the all-events and economic performance tests are met. At that point, the possible permutations of deduction and/or capitalization for the transferor and the transferee are as follows:

- Transferor gets no deduction (with no gain recognition except under section 357(b) or (c)); transferee gets the deduction, either because the expenditure is treated as a transferee expense (not an assumed liability), or because there is an assumed liability, but the transferee steps into the transferor's shoes under Rev. Rul. 95-74 (*see* part X.C.3.b., above).
- Transferor gets the deduction (with no gain recognition except under section 357(b) or (c)); transferee gets no deduction and no asset basis step-up, except to the extent of the transferor's gain recognition, if any.

- Transferor gets no deduction (with no gain recognition except under section 357(b) or (c)); transferee gets no deduction and no asset basis step-up (*Holdcroft Transportation Co.*).

The transferor's basis in the stock of the transferee also could be affected in various ways:

- No stock basis reduction because no "liability" (sections 357(c)(3) and 358(d)) and/or no "assumption" (section 357(d)).
- Loss disallowance on the stock under section 358(h).
- Stock basis reduction at the time of the transfer.
- Stock basis reduction when all-events and economic performance tests are met (parity with transferor treatment).
- Possible double counting of stock basis reduction in consolidated return has been eliminated by Reg. § 1.1502-80(d) (generally turning off section 357(c) within a consolidated group).

b. Relationship Between Deduction of Contingent Liability and Transferor's Stock Basis

If the transferor gets no tax benefit (no deduction or step-up in asset or stock basis) from its incurring of the contingent liability or from the transferee's payment of the liability, then the transferor's basis in the stock of the transferee should not be reduced by the transferee's assumption of the liability. On the other hand, if the transferor does get tax benefit from any of these events, the transferor's basis in the stock of the transferee should be reduced to reflect the fact that it got a tax benefit at no cost.

c. Implementation

These principles could be implemented in several ways, all arguably consistent with the Code but all flawed, including the following:

- Limit favorable treatment under sections 357(c)(3) and 358(d)(2) to liabilities that are deductible to (or capitalized by) the transferee upon accrual or payment by the transferee, under a "step-into-the-shoes" treatment test like that of Rev. Rul. 95-74. If the transferor is entitled to a deduction, even in the future, reduce the transferor's basis in the transferee stock by the amount of the assumed liability at the time of the exchange. If the transferor's stock basis is exhausted, gain is recognized to the transferor under section 357(c). The advantage of this method is that it would produce consistent treatment of the transferee's deduction and the transferor stock basis reduction. On the other hand, the language of section 357(c)(3) is broad enough to encompass any liabilities not reflected in the tax system (asset basis or prior deduction) at the time of the asset transfer. For this reason, the courts of appeals in both *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 167 L.Ed.2d 76 (2007), rejected the idea of limiting the benefits of section 357(c)(3) and 358(d)(2) to liabilities that would result in deductions by the transferee. In addition, a double hit from this stock basis adjustment and loss disallowance under section 358(h) would have to be prevented.

- If the payment of a liability by the transferee results in a deduction to the transferor, the payment could be treated, not as a liability assumption under section 357, but as taxable boot. The results would be gain recognition to the transferor (with an offsetting deduction) and asset basis step-up to transferee. This method would prevent net tax benefit to the transferor for amounts not paid by it (except for character, if the recognized gain is capital gain). On the other hand, this method could accelerate taxable gain recognition in non-abusive transactions.
- Apply favorable treatment under sections 357(c)(3) and 358(d)(2) to all liabilities not yet taken into account at time of exchange either as a transferor deduction or in the transferor's asset basis (*i.e.*, regardless of whether the transferor or the transferee gets a deduction later). But if the transferor is entitled to deduct an amount paid later by the transferee, the transferor's basis in the transferee stock would be reduced by the amount of the deduction and, if the stock basis is exhausted, the transferor would recognize gain under section 357(c). This method would provide consistent treatment of transferee deductions and transferor stock basis reductions. Also, such a rule would be administrable, because all tax reporting would be in the hands of the transferor. It would be consistent with section 358(h) with no need for an adjustment to avoid a double hit. As a disadvantage, however, such a rule could allow artificial timing benefits to the transferor before the deduction is taken into account, although section 358(h) would limit this benefit.
- Deny deduction to the transferor for contingent liabilities assumed by the transferee in all cases. *Holdcroft Transportation Co.* In effect, the transferor would get basis in the stock of the transferee in lieu of a deduction. In cases where the transferee is not entitled to a deduction, the transferee would get additional basis in the transferred assets by the amount of payment of the assumed liability. This method would prevent net tax benefit to the transferor for amounts not paid. But it could eliminate ordinary deductions to which one of the parties should be entitled (inconsistent with treatment of taxable asset sales).

5. Contingent Liabilities in Divisive Type-D Reorganizations and Other Tax-Free Spin-offs

a. Assumption of Contingent Liabilities by Spun-Off Subsidiary

In connection with divisive type-D reorganizations and other spin-offs, the distributing parent ("Distributing") and the spun-off subsidiary ("Controlled") enter into agreements relating to contingent liabilities of the business being spun-off. Under this type of agreement, Distributing may retain the liabilities, or Controlled may assume them. Whichever party has legal liability, the other party may indemnify that party.

In several private rulings, IRS has ruled that payments by Distributing to Controlled, or vice versa, pursuant to these types of agreements are deemed to relate back to a time immediately before the spin-off. *See*, *e.g.*, PLR 199919025 (Feb. 12, 1999). This conclusion does not specify the actual treatment of the payment as, *e.g.*, a distribution or payment of "boot" by Controlled to Distributing or a capital contribution by Distributing to Controlled. Nor does it specify which party is entitled to the deduction if the item is deductible when paid or accrued.

Under section 357(d), an assumption of liabilities by Controlled for tax purposes can be effected either by a legal assumption (with no indemnity from Distributing) or by an indemnity to

Distributing. In other words, the concept of an "assumption" is the same in a divisive type-D reorganization as in a section 351 exchange. *See* part X.C.3., above.

Similarly, Rev. Rul. 95-74 should apply to a divisive type-D reorganization in the same manner as to a section 351 exchange. In Rev. Rul. 95-74, IRS ruled that the transferee corporation in a section 351 exchange may deduct payments of contingent liabilities incurred by the transferor, so long as the business or assets that generated the deduction are also transferred. *See* part X.C.3.b., above. CCA 201023056 (Sept. 22, 2009) adopts the view that, if Controlled assumes a contingent liability in a divisive type-D reorganization, it may deduct its payment of the liability under the same theory as in Rev. Rul. 95-74, but that relief under section 1341 (claim of right adjustments) is not available.

If Controlled is a pre-existing corporation and is spun-off with no type-D reorganization or other asset transfer, and if Controlled assumes a contingent liability from its parent, may Controlled deduct the payment when made? Such a transaction does not resemble a section 351 exchange, and therefore the analogy to Rev. Rul. 95-74 is less clear than in the case of a divisive type-D reorganization. On the other hand, if the contingent liability arose in connection with Controlled's business, it may make sense to allow the deduction to Controlled.

b. Stock Options and Restricted Stock

In Rev. Rul. 2002-1, 2002-1 CB 268, Distributing granted restricted Distributing stock and nonqualified options on Distributing stock to employees. Then, upon Distributing's tax-free spin-off of Controlled, the employees' rights were cancelled, and restricted stock and nonqualified options on both Distributing and Controlled stock were substituted. IRS ruled that, when the restrictions on stock lapsed and the options were exercised (as the case may be), no gain or loss was recognized to either Distributing or Controlled, and Distributing and Controlled each was entitled to deductions with respect to their own employees.

D. Assumptions of Liabilities in Corporate Tax Shelter Transactions

1. Section 357(d)

After the tax shelter boom of the 1990s and early 2000s, legislative and regulatory efforts were undertaken to clarify what is meant by "assuming" a liability. The changes were intended to prevent abuse and to eliminate non-economic results. In 1999 Congress amended sections 357(a) and (c) and enacted section 357(d) to clarify the concept of "assumption" of a liability. Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(1) (106th Cong., 1st Sess. 1999). Treasury and IRS have issued an Advance Notice of Proposed Rulemaking soliciting comments on a variety of issues under section 357(d). Advance Notice of Proposed Rulemaking, Liabilities Assumed in Certain Transactions (Announcement 2003-37, 2003-1 CB 1025), REG-100818-01, RIN 1545-A474, 68 Fed. Reg. 23,931 (May 6, 2003).

a. Recourse Liabilities

A recourse liability is now considered "assumed" for tax purposes only if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy the liability. Section 357(d)(1).

b. Nonrecourse Liabilities

Nonrecourse liabilities are considered assumed only to the extent they do not attach to assets which are not transferred in the exchange. This rule is implemented, first by treating a nonrecourse liability as assumed if any asset subject to that liability is transferred, and second by reducing the amount assumed by the lesser of (i) the amount of the liability which the owner of non-transferred assets agrees to and is expected to satisfy, or (ii) the fair market value of the other assets. Sections 357(d)(1)(B), (d)(2). The Advance Notice of Proposed Rulemaking (*see* part X.D.1., above) questions whether a different set of rules should be used to determine if a nonrecourse liability has been assumed.

2. Cross-Collateralized Debt

One tax shelter involved the transfer of several items of property, all subject to the same liability, to separate corporations. The proponents of the shelter added the full amount of the liability to the basis of each property, so that one liability resulted in multiple basis step-ups. The treatment of recourse debt under section 357(d) (part X.D.1.a., above) prevents one liability (contingent or fixed) from resulting in multiple basis step-ups.

3. BOSS Transactions – Reg. § 1.301-1(g)

Ambiguity in the meaning of "assumption" of liabilities had also led to abuse in the context of corporate distributions. Notice 99-59, 1999-2 CB 761 ("BOSS" transactions). To prevent this abuse, regulations were adopted in January 2001 to apply the section 357(d) definition of "assumption" to distributions under section 301. Temp. Reg. § 1.301-1T(g), covering distributions after January 4, 2001, and some earlier transactions which are substantially similar to the BOSS transaction. The regulation was finalized in April 2001. Reg. § 1.301-1(g).

4. Rules to Address Contingent Liability Shelters and Similar Transactions

a. Background

Another tax shelter designed to take advantage of the liability assumption rules involves a transfer of a high basis asset (usually cash or cash equivalents) to a corporation in exchange for stock and the assumption by the corporation of a contingent liability. As a result, the fair market value of the stock issued in the exchange is close to zero. Under sections 357(c)(3) and 358(d), however, the contingent liability does not reduce the basis of the issued stock, and Taxpayers then sell the stock at fair market value, recognizing a duplicated loss.

b. Early IRS Responses and Notice 2001-17

IRS first attacked this "contingent liability" shelter in FSA 199905008 (Oct. 29, 1998), *reconsidered*, FSA 199929015 (Apr. 20, 1999) and TAM 200006014 (Oct. 22, 1999). Then, in Notice 2001-17, 2001-2 CB 730, IRS designated the contingent liability tax shelter as a "listed" transaction under Temp. Reg. § 1.6011-4T(b)(2) and stated the intention to challenge it using a number of broad-based arguments and followed up with FSA 200122022 (June 1, 2001), FSA 200121013 (May 25, 2001), FSA 200134008 (Aug. 24, 2001) and CCA 200117039 (Apr. 27, 2001). In Rev. Proc. 2002-67, 2002-2 CB 733, IRS provided two alternative procedures to settle cases involving these transactions.

c. Case Law

In each of two court tests of the shelter, the taxpayers prevailed in the trial court but lost on appeal. *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), *aff'g in part, rev'g and remanding in part* 340 F. Supp. 621 (D. Md. 2004); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *rev'g* 94 AFTR 2d 2004-6708 (Ct. Fed. Cl. 2004). In each case, the court of appeals concluded that the loss would be available under a technical interpretation of the statutory provisions then in effect (*i.e.*, without section 358(h), enacted later), but held that the transaction lacked economic substance. In *Coltec*, the Federal Circuit held that this conclusion was sufficient to disregard the transactions and disallow the loss. In *Black & Decker*, the Fourth Circuit remanded the case for a determination of whether, even though lacking objective economic substance, the transactions had a non-tax business purpose that would rescue them.

d. Section 358(h)

Section 358(h), enacted in 2000, eliminates the contingent liability shelter with a new loss disallowance rule, effective for transfers on or after October 18, 1999. Section 358(h)(1) reduces the basis of stock to the extent that (i) it exceeds the stock's fair market value, and (ii) liabilities are assumed by the transferee corporation. For this purpose, liabilities include contingent liabilities, even those that have not otherwise been yet taken into account under the Code.

Under section 358(h)(2), stock basis is not reduced by a liability if the assets transferred to the corporation as part of the exchange include either (i) the trade or business associated with the liability, or (ii) substantially all of the assets associated with the liability. In Reg. § 1.358-5, however, Treasury used its authority under section 358(h)(2) to eliminate the "substantially all" exception.

e. Reg. § 1.1502-36

Reg. § 1.1502-36 disallows losses on sales of stock of consolidated group subsidiaries where the loss is artificial. Even if the loss is a real economic loss, the regulation reduces Target's tax attributes (loss carryovers, asset basis, etc.) after the sale to prevent duplication of tax benefits. If Target has contingent liabilities that are paid and deducted (or capitalized later), attributes may be reduced at that time. *See* part V.C.2.d., above.

f. Section 362(e)(2)

Section 362(e)(2), enacted with section 358(h) in 2004, was intended to prevent double deductions resulting from transfers of built-in loss property to corporations. It reduces the basis of such property from carryover basis to fair market value and allows the transferor to elect instead to reduce the basis of the stock it receives.

This provision applies if the basis of property transferred to a corporation is greater than the fair market value of the property. If the transferee corporation assumes a liability (contingent or otherwise) from the transferor, the value of the transferred property is not reduced, and its basis is not increased. Thus, section 362(e) does not apply. Section 358(h) addresses any built-in loss problem attributable to liabilities. *See* Reg. § 1.362-4(h) Example (5) (section 351 property transfer with assumption of fixed and contingent liabilities).

As a technical matter, section 362(e) could apply to a transfer of an interest in a partnership with liabilities. Because basis in a partnership interest includes the allocable share of partnership liabilities, basis could exceed value, but there is no built-in loss in the usual sense. *See* Rev. Rul. 80-323, 1980-2 CB 124 (in section 351 transfer of partnership interest, partnership liabilities allocable to transferred interest treated as assumed, subject to section 357, including section 357(c)). To address this problem, the regulations deem an increase in the "value" of the partnership interest for section 362(e)(2) purposes by the amount of liabilities allocable to the transferred interest in the hands of the transferee. Reg. §§ 1.362-4(g)(12)(ii), 1.362-4(h) Example (8)(ii).

E. Partnership Liabilities and Tax Shelters

1. Regulations in General

Reg. §§ 1.358-7, 1.752-1, 1.752-6 and 1.752-7, TD 9207, 70 Fed. Reg. 30,334 (May 26, 2005), deal with variations on the contingent liability shelter involving partnerships. The regulations apply, however, to situations well beyond any specific shelter. Moreover, the implications of the regulations extend beyond partnership taxation into the corporate world.

2. Reg. § 1.752-6

This regulation applies a section 358(h)-like rule to assumptions by partnerships of liabilities incurred after October 18, 1999, and before June 23, 2003, when later temporary regulations were adopted (TD 9062, 68 Fed. Reg. 37, 414 (June 24, 2003).

In a section 721 transaction (a transfer of property to a partnership for a partnership interest), if the partnership assumes a "liability" (defined in the broad terms of section 358(h) to include contingent liabilities and the like), the partner's basis in its partnership interest is reduced. The amount of the reduction is the full amount of the liability, but only up to the amount necessary to eliminate a built-in loss in the partnership interest.

For "Son-of-BOSS" and substantially similar transactions (Notice 2000-44, 2000-2 CB 255), the only exception to this rule is the one for a transfer of the trade or business associated with the liability. The section 358(h) exception for a transfer of substantially all the assets associated with the liability does not apply. Otherwise both exceptions in section 358(h)(2) (without Reg. § 1.358-5, discussed in part X.A.4., above) apply—transfers of a trade or business associated with the liability and transfers of substantially all of the assets associated with the liability assumed.

Reg. § 1.752-6 was said to be effective retroactively from the date of enactment of section 358(h) (October 18, 1999) but not after the date of publication (June 24, 2003). The preamble to TD 9062 explains the retroactive treatment by referring to a non-Code provision in the statute enacting section 358(h). Consolidated Appropriations Act of 2001, Pub. L. No. 106-554 (106th Cong. 2d Sess. 2000), § 309(c). This provision directs Treasury to prescribe section 358(h)-like rules for partnership transactions. This unusual cut-off of effectiveness on the date of publication is due to the fact that a more elaborate regime in the regulations (described in part X.E.3., below) took effect on that day.

Taxpayers may elect to apply Reg. §§ 1.752-1 and 1.752-7 (described in part X.A.4.c., below), instead of Reg. § 1.752-6, to transactions occurring from October 18, 1999, through June 24, 2003. The election to do so must be filed with the partnership's return filed on or after September 24, 2003, and on or before December 31, 2005.

Reg. § 1.752-6 has had a mixed reception from the courts in Son-of BOSS transaction cases, although the outcomes have favored the government.

In *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), the court applied Reg. § 1.752-6 against taxpayer retroactively, in accordance with its terms, and the loss created in a Son-of-BOSS transaction was disallowed. In *Maguire Partners Master Investments, LLC v. United States*, 104 AFTR 2d 2009-7839 (N.D. Cal. 2009), the court reached the same conclusion. In *Stobie Creek Investments, LLC v. United States*, 102 AFTR 2d 2008-5442 (Ct. Fed. Cl. 2008), the court held retroactive application of Reg. § 1.752-6 invalid but found no economic substance in the transaction. In *Murfam Farms, LLC v. United States*, 104 AFTR 2d 2009-5700 (Ct. Fed. Cl. 2009), the court denied a Government motion for summary judgment and again held retroactive application of Reg. § 1.752-6 invalid. Later, this case was settled with a stipulation that the transaction involved lacked economic substance. Based on the settlement, the Government moved to have the earlier decision vacated, but its motion was not successful. 106 AFTR 2d 2010-5960 (Ct. Fed. Cl. 2010).

In a number of other cases, the courts upheld the Government's position but avoided passing on the validity of Reg. § 1.752-6. In *Klamath Strategic Investment Fund, L.L.C. v. United States*, 98 AFTR 2d 2006-5495 (E.D. Tex. 2006), 472 F. Supp. 885 (E.D. Tex. 2007), *reconsideration denied*, 99 AFTR 2d 2007-2001 (2007), *aff'd*, 103 AFTR 2d 2009-2220 (5th Cir. 2009), the district court held that Reg. § 1.752-6 could not be applied retroactively against the taxpayer, because the taxpayer was justified in relying on prior law, but disallowed the claimed loss, because the transactions lacked economic substance. The court of appeals declined to take up the retroactivity issue but affirmed on the grounds relied on by the district court. In *Sala v. United States*, 101 AFTR 2d 2008-1843 (D. Colo. 2008), *rev'd*, 613 F.2d 1239 (10th Cir. 2010), the district court held that Reg. § 1.752-6 could not be applied retroactively and allowed the tax benefits of a Son-of BOSS transaction as having economic substance. The court of appeals reversed on economic substance grounds, but, as in *Klamath*, did not address Reg. § 1.752-6. In *Kornman & Associates, Inc. v. United States*, 527 F.3d 443, 461 (5th Cir. 2008), *aff'g Colm Producer, Inc. v. United States*, 460 F. Supp. 713 (N.D. Tex. 2006), the loss created in a short sale Son-of BOSS transaction was disallowed, because the partnership's short sale obligation was treated as "liability" under section 752, as provided in revenue rulings in effect before Reg. § 1.752-6, and that regulation was held inapplicable. In *7050 LTD. v. Commissioner*, T.C. Memo. 2008-112, a loss in a Son-of BOSS transaction was disallowed on the merits of economic substance, because the options purportedly transferred to the partnership had expired before the transfer, and because the distribution of the options by the partnership to the partner did not fully liquidate partner's interest.

For a review of the Son-of-BOSS cases decided as of June 2009, *see* M. Jackel & R. Crnkovich, "Son-of-BOSS Revisited," 123 Tax Notes 1481 (June 22, 2009). Later cases generally have continued the Government's winning streak without reaching the validity of Reg. § 1.752-6. *Marriott Int'l Resorts, LP v. United States*, 102 AFTR 2d 2008-6039 (Ct. Fed. Cl. 2008); *Clearmeadow Investments, LLC. v. United States*, 103 AFTR 2d 2009-2786 (Ct. Fed. Cl. 2009); *Bemont Investments, LLC v. United States*, 106 AFTR 2d 2010-5542 (E.D. Tex. 2010); *Candyce Martin 1999 Irrevocable Trust v. United States*, 108 AFTR 2d 2011-6693 (N.D. Cal. 2011).

3. Reg. §§ 1.358-7, 1.752-1 and 1.752-7

The permanent regulations embody a rethinking of partnership liabilities, especially contingent liabilities. In fact, the permanent regulations include a framework for analyzing liabilities that may apply to corporate and other liabilities in the future.

The most innovative features of the regulations are the broad concept of "obligation" (for section 752 purposes) and the division of obligations into two categories. "Obligations" are all obligations to make payments, including both fixed and contingent obligations, regardless of whether taken into account in the tax system (*e.g.*, in creating a deduction or asset basis). Reg. § 1.752-1(a)(4)(ii). This broad concept of obligation is divided into two categories for section 752 purposes:

- A "liability" is an obligation that already has been (or never will be) taken into account in the tax system—an obligation that has given rise to basis in an obligor's asset or in an immediate deduction and an obligation that is neither deductible nor chargeable to capital account. The regulations define the category but do not change the treatment of these "liabilities". They continue to be taken into account under normal tax accounting principles, and liabilities of a partnership are allocated among partners and affect their basis in their partnership interests under section 752 as before.
- All other obligations are referred to as "§ 1.752-7 liabilities." These are generally unpaid and unfixed contingent obligations, including environmental, pension, contract and short sale obligations and the like. These are obligations that have not yet been taken into account in the tax system but will be taken into account in the future. The treatment of these § 1.752-7 liabilities overrules *Helmer v. Commissioner*, T.C. Memo. 1975-160 (option written by partnership not a liability under § 752), to the extent necessary to eliminate prevent double deductions, accelerated deductions and loss shifting—on which the Son-of-BOSS shelter was based.

With these definitions and others setting the stage, the regulations establish a new regime for dealing with a partner's § 1.752-7 liabilities that a partnership or another partner assumes.

One approach could have been simply to reduce a partner's basis in its partnership interest whenever a § 1.752-7 liability is assumed by the partnership and is allocated to another partner. But this approach would have led to two problems—an abuse and an unfairness:

- It would have allowed the tax benefit (*e.g.*, the business expense or depreciation deduction) generated by the § 1.752-7 liability to be reallocated from the partner that incurred the liability to other partners.
- When the § 1.752-7 liability was paid or otherwise taken into account, a second basis reduction would have been suffered by the partners to whom the liability was allocated.

Instead, the regulations prevent double deductions, accelerated deductions and loss shifting, all without duplicated basis reductions. They accomplish these goals by identifying the liability with the partner who transferred it to the partnership. The deduction or asset basis attributable to a § 1.752-7 liability remains with the partner that incurred the § 1.752-7 liability (referred to as the "§ 1.752-7 liability partner"), under section 704(c) principles.

- Thus, when a partnership satisfies a § 1.752-7 liability, the resulting deduction or asset basis increase is allocated to the § 1.752-7 liability partner who incurred the liability, to the extent of his or her built-in loss at the time of the assumption of the liability. This reduction in liability allocated to the § 1.752-7 liability partner results in a reduction in its basis in its partnership interest. (The deduction or inside asset basis increase adjusts partnership interest basis separately.)
- The section 704(c) regulations are also amended to treat any partnership property whose basis is increased when a § 1.752-7 liability is paid "as section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized." Reg. § 1.704-3(a)(8)(iv).

These rules bear some similarity to the treatment of assumed contingent liabilities in asset sales. In an asset sale, upon satisfaction of the liability by Acquiror (at the latest), the Target that incurred the liability is deemed to receive additional amount realized on the sale with an offsetting deduction. Acquiror treats the payment in satisfaction of the liability as additional purchase price for the purchased assets, not as a deduction. *See* part IV.D., above. But, unlike the asset sale situation, the amount of the § 1.752-7 liability that is allocated specially to the § 1.752-7 liability partner is limited to the amount necessary to eliminate that partner's built-in loss (if any) in the partnership interest at the time the liability is assumed.

What happens if the § 1.752-7 liability partner becomes separated from its partnership interest and therefore from its § 1.752-7 liability? For example, a § 1.752-7 liability partner might sell its partnership interest or have its interest liquidated before the § 1.752-7 liability is satisfied.

- In this situation, the regulations trigger a reduction in the § 1.752-7 liability partner's basis in its partnership interest at the time of the separation. Again, the amount of the reduction is the amount necessary to eliminate a built-in loss in this basis resulting from the partnership's assumption of the § 1.752-7 liability.
- Here is another parallel with the treatment of taxable asset acquisitions. In determining the amount of the § 1.752-7 liability to compute the built-in loss and basis reduction, the regulations "value" the § 1.752-7 liability at the hypothetical amount the obligor would have had to pay an unrelated party to assume the liability. *See* discussion of *James M. Pierce Corp.* in part IV.E., above. But again, unlike the asset sale situation, the amount of the § 1.752-7 liability that is actually taken into account here is limited to the amount necessary to eliminate the partner's built-in loss (if any) in his or her partnership interest at the time the liability is assumed.
- After a § 1.752-7 liability partner has become separated from its § 1.752-7 liability, the partnership (or another partner) might pay the § 1.752-7 liability. In this case, the paying partnership or partner is not entitled to a deduction or other tax benefit associated with the payment, to the extent of the § 1.752-7 liability partner's built-in loss not previously accounted for. Instead, the payor is to notify the § 1.752-7 liability partner of the payment or other satisfaction of the liability, and that partner is entitled to the deduction, up to his or her built-in loss. The other partners do not suffer reduction in their basis in their partnership interests.

One of the section 358(h) exceptions—the one relating to transfers of active businesses—applies in partnership situations. There is also a *de minimis* exception for situations in which the built-in loss on all § 1.752-7 liabilities assumed by the partnership is less than 10% of the partnership's gross assets, up to $1 million. As with transfers to corporations (*see* part X.A.4., above), a transfer to a partnership of substantially all the assets related to a § 1.752-7 liability assumed by the partnership does not prevent the liability from being subject to the Reg. § 1.752-7 regime.

The regulations also include special rules dealing with all "liabilities" (defined for this purpose by reference to section 358(h)—a definition similar to the definition of "obligation" in the section 752 regulations) assumed by a partnership and then assumed from the partnership by a corporation.

The preamble to the proposed regulations pointed out that concepts in the proposed regulations could find their way into corporate tax rules. Specifically, the definition of "liability" may find application for subchapter C purposes. 68 Fed. Reg. 37,434 at 37,436 (June 24, 2003).

F. Contingent Liabilities in Like-Kind Exchanges

1. General Treatment of Assumed Liabilities

If a taxpayer transfers property in a like-kind exchange, and the transferee assumes a liability (*e.g.*, a mortgage) or takes the property subject to a liability, the taxpayer has "boot," as though it had received cash, and so may recognize gain in the exchange. But, if a taxpayer transfers property subject to a liability and also assumes a liability of the other party, or takes the replacement property subject to a liability, the amounts of the liabilities are offset.

2. Issues Regarding Contingent Liabilities

There are no authorities applying these general principles to contingent liabilities. Thus, issues arise if a taxpayer transfers property in a like-kind exchange and either transfers a contingent liability with the property or takes on a contingent liability with the replacement property:

a. Contingent Liabilities Transferred by Taxpayer

If the value of the taxpayer's transferred contingent liability can be determined at Closing, does the taxpayer take the liability into account as boot at Closing (*i.e.*, "closed transaction" approach)? If so, is the liability offset against contingent liabilities the taxpayer assumes?

If the value of the taxpayer's transferred contingent liability cannot be determined at Closing, is the receipt of the boot deferred in an "open transaction" approach? If so, when the liability is paid, is the payment treated as a liability transfer (subject to netting) or as a receipt of other boot (not subject to netting)?

If a taxpayer incurs a liability in an acquisition of property, and if the liability is not reflected in the taxpayer's basis in the property, the transfer of the liability in a later sale of the property is excluded from amount realized. Reg. § 1.1001-2(a)(3). Does this rule apply if the taxpayer disposes of the property in a like-kind exchange? If so, does it matter whether the acquisition was a taxable transaction (so that the gain was recognized to Seller from the taxpayer's assumption of the liability) or a tax-free exchange (so that the taxpayer assumed a pre-existing liability that was not reflected in the transferor's basis)?

b. Contingent Liabilities Assumed by Taxpayer

If the taxpayer assumes, or takes replacement property subject to, a contingent liability, can this contingent liability be netted against either a fixed liability or a contingent liability transferred to the party that receives the transferred property?

If the taxpayer sells the replacement property subject to a contingent liability that the taxpayer had previously assumed, is the liability excluded from amount realized (Reg. § 1.1001-2(a)(3))?

CONTINGENT CONSIDERATION, CONTINGENT LIABILITIES AND INDEMNITIES IN ACQUISITIONS

REFERENCES

WILLIAM AND MARY TAX CONFERENCE
NOVEMBER 6-7, 2014

KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA

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

SEPTEMBER 2014

TABLE OF CONTENTS

CONTINGENT CONSIDERATION, CONTINGENT LIABILITIES AND INDEMNITIES IN ACQUISITIONS

REFERENCES

WILLIAM AND MARY TAX CONFERENCE
NOVEMBER 6-7, 2014

KINGSMILL RESORT
WILLIAMSBURG, VIRGINIA

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

SEPTEMBER 2014

TAXABLE ACQUISITIONS

TAXABLE ASSET AND STOCK ACQUISITIONS - CONTINGENT PURCHASE PRICE

Code Provisions

Sections 336(e) and 338(h)(10) (deemed asset sale on certain sales of stock with election)

Section 453(a)(2), repealed (prohibition on installment method for accrual method taxpayers, repealed Installment Tax Correction Act of 2000, Pub. L. No. 106-573 (106th Cong., 2d Sess. 2000).)

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 1234A (dictates "sale or exchange" treatment for cancellation, lapse, expiration or other termination of a right or obligation with respect to certain property which is (or would be upon acquisition) a capital asset in the hands of the taxpayer)

Section 1271(a) (redemption by a borrower of debt instrument is a "sale or exchange")

Section 1253(d) (current deduction for certain payments for franchises, trademarks and trade names)

Section 1275(a)(1) (debt instrument is "a bond, debenture, note, or certificate or other evidence of indebtedness")

Section 1275(d) (regulation authority for OID treatment of contingent debt instruments)

Legislative History

S. Rep. No. 1000, 96th Cong., 2d Sess. 24 (1980) (open transaction in installment sales "rare and extraordinary")

H.R. Rep. No. 103, 103d Cong., 1st Sess. 685 (1993) (basis of § 197 intangibles adjusted for contingent purchase price)

H.R. Conf. Rep. No. 105-220 at 454 (1997) (1234A designed to overturn cases, like Pittston, that employed the extinguishment doctrine)

S. Rep. No. 33, 105th Cong., 1st Sess. 132, 133 (1997) (1234A designed to overturn cases, like Pittston, that employed the extinguishment doctrine)

Current Regulations, Proposed Regulations and Possible Future Guidance

Reg. § 1.61-6(a) ("When part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts. … [G]ain or loss shall be determined at the time of sale of each part and not deferred until the sale of the entire property." That is, open transaction doctrine limited to "rare and extraordinary cases," as provided in Reg. § 1.1001-1(a))

Reg. § 1.166-1(c) (bad debt deduction available only for "fixed and determinable" obligations)

Reg. § 1.167(a)-14(b) (36-month amortization for publicly-available computer software)

Reg. § 1.167(a)-14(c)(2)(ii) (the basis of right to fixed amount is amortized for each taxable year by multiplying the basis by fraction, numerator of which is amount received during taxable year and denominator is total amount to be received under the contract)

Reg. § 1.167-14(c)(4) (providing rules for amortizing payments for interests in patents and copyrights not acquired as part of an acquisition of a trade or business)

Reg. § 1.197-2(a)(3) (15-year amortization under § 197 does not apply to amounts otherwise deductible)

Reg. § 1.197-2(b)(11) (amounts paid for use of intangibles generally amortized over 15 years under § 197)

Reg. § 1.197-2(c)(7) (interests in patents and copyrights not acquired as part of an acquisition of a trade or business not § 197 intangibles)

Reg. § 1.197-2(e)(2)(ii)(C) (acquisition of franchise, trademark or trade name not per se acquisition of trade or business (so that cost of other intangibles may be deductible), if all substantial rights, or undivided interest, not transferred under § 1253 principles)

Reg. §§ 1.197-2(f)(2), (f)(3)(iv)(B) (if payment for use of intangible is capitalized under § 197 and included in basis after 15-year period begins, payment is amortized over remainder of 15-year period; each payment treated as payment on a debt instrument, so that portion may be currently-deductible interest; remainder of payment amortized over remaining 15-year period after closing, or currently deductible if made more than 15 years after closing)

Reg. § 1.197-2(f)(3)(ii)(A) (with exceptions noted, payments for right to use intangibles amortizable under § 197 if acquired "as part of a purchase of a trade or business")

Reg. §§ 1.197-2(f)(3)(ii)(B), (f)(3)(iv)(B)(1) (payments for right to use know-how and information base (other than customer base) not chargeable to capital account, if all substantial rights, or undivided interest, not transferred under § 1235 principles, and transferred for arm's-length consideration; close scrutiny for sale or exchange treatment under § 1235 principles)

Reg. §§ 1.197-2(f)(3)(ii)(B), (f)(3)(iv)(B)(3) (treatment of other parties not determined by application of Reg. §§ 1.197-2(f)(3) to include an asset in buyer's capital account)

Reg. § 1.197-2(g)(6) (amounts paid for franchise, trademark or trade name subject to § 1253(d)(1)(B) (contingent serial payments) deductible; all other payments for franchise, trademark or trade name amortizable under § 197)

Reg. § 1.197-2(k) Examples 5-10 (various rights that do and do not constitute § 197 intangibles)

Reg. §§ 1.263(a)-4 and 1.263(a)-5 (expenditures to acquire or create intangibles, including a trade or business)

Reg. § 1.336-1(a)(1) (§ 338(h)(10) model applies to stock sales with § 336(e) election, *e.g.*, availability of installment method in deemed asset sale (*see also* Reg. § 1.336-2(b)(1)(i)(B)(1))

Reg. § 1.336-2(b)(2)(i)(A) (ADADP redetermined as in Reg. § 1.338-7)

Reg. § 1.336-3(b)(1)(ii) (for ADADP purposes, same rule as Reg. § 1.338-4(b)(2)(ii))

Reg. § 1.336-3(d) (for ADADP purposes, Target liabilities are measured as of beginning of day after disposition date, but transactions that take place on disposition date after Closing, not in ordinary course of business, treated as occurring on day after disposition date

Reg. § 1.336-4 (AGUB under § 336(e) determined as in Reg. § 1.338-5)

Reg. § 1.338-4(b)(2)(ii) (for ADSP (seller) purposes, if contingent purchase price is taken into account before end of new Target's taxable year in which the stock purchase occurs, it relates back to day after acquisition date; if not, purchase price allocation is adjusted later and results in redetermination of purchase price allocation under residual method)

Reg. § 1.338-5(b)(2)(ii) (for AGUB (buyer) purposes, if contingent purchase price is taken into account before end of New T's taxable year in which the stock purchase occurs, it relates back to day after acquisition date)

Reg. §§ 1.338-7(b) (redetermination of ADSP results in re-allocation of purchase price under residual method)

Reg. §§ 1.338-7(c), (d) (if adjustment to AGUB or ADSP occurs after Old T has gone out of existence, additional gain or loss is accounted for by Old T shareholders)

Reg. § 1.338(h)(10)-1(d)(8)(i) (shareholder tax liabilities deemed assumed in § 338(h)(10) stock sale treated as cash)

Reg. §§ 1.446-1(c)(1)(ii)(A) and 1.451-1(a) (income includable in gross income of accrual method taxpayer when all events have occurred that fix the right to receive, and amount can be determined with reasonable accuracy)

Reg. § 15a.453-1(b)(3)(i) (a "payment" includes receipt of indebtedness issued by a party other than Acquiror)

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 at closing if seller elects out of installment method)

Reg. § 1.461-4(e) (amounts are deductible when liability is fixed or paid)

Reg. § 1.483-4(a) (imputed interest on contingent payment obligations under § 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 right to contingent payments)

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

Reg. § 1.1060-1(c)(1) (total purchase price allocated among purchased assets under residual method but only up to FMV of each asset, other than goodwill in class VII)

Reg. § 1.1274-2(g) (contingent payments not included in property basis until they become fixed)

Reg. § 1.1275-1(d) (debt instrument is an "instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law")

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)

Prop. Reg. § 1.1001-1(j) (2006) (sale of property for annuity treated as sale under closed transaction method with amount realized equal to FMV of annuity determined under § 7520; Rev. Rul. 69-74 to be reversed)

Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Tax Accounting ¶¶ 13 (sales of properties for annuities), 14 (installment sale deferral charge)

Regulations Applicable to Qualified Stock Purchases On or Before January 5, 2000

Reg. § 1.338(b)-3T(b) (definition of "contingent amount")

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 §§ 338(g) and 338(h)(10), in determining AGUB and asset basis; reductions of consideration or liabilities taken into account when the reduction "occurs")

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

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

Reg. § 1.338(b)-3T(g) (special allocation of consideration to contingent income assets; *see* Associated Patentees and § 197 regulations – eliminated in new temporary and final regulations (64 Fed. Reg. 43461 at 43470))

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

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

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")

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

Reg. § 1.1060-1T(f)(4) (allocation of consideration to contingent income assets; *see* Associated Patentees and § 197 regulations – eliminated in new temporary and final regulations; *see* 64 Fed. Reg. 43461 at 43470)

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)

Burnet v. Harmel, 287 U.S. 103, 106 (1932) (capital gain treatment only for "situations typically involving the realization of appreciation in FMV accrued over a substantial period of time)

Fairbanks v. United States, 306 U.S. 436 (1939) (redemption by borrower of its own debt instrument not a sale or exchange) (overturned by § 1271)

Hort v. Commissioner, 313 U.S. 28 (1941) (surrender of lease by tenants to landlords for cash results in ordinary income for landlords because payments replace what would have been ordinary income from rent)

Rhode's Est. v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (sale of right to declared but unpaid dividends yields ordinary income)

Pierce v. United States, 49 F. Supp. 324 (Ct. Cl. 1943) (no loss on sale of right to proceeds if liquidation of stapled bank affiliate corporation by bank shareholder; proceeds offset against full basis of bank stock)

Inaja Land Co. v. Commissioner, 9 T.C. 727 (1947) (proceeds of sale of land easement all offset against full basis in land under open transaction method)

Bell's Estate v. Commissioner, 137 F.2d 14 (8th Cir. 1943) (life tenant's transfer of interest to remainderman generates capital gain)

Associated Patentees v. Commissioner, 4 T.C. 979 (1945) (cost to purchase patent, based on percentage of income earned thereon, deducible as paid)

Allen v. First National Bank and Trust Co., 157 F.2d 592 (5th Cir. 1946) (life estate is a capital asset)

Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952) (corporate liquidation in which shareholder received loans, mortgages, etc., was closed transaction; later gain from collections was ordinary income)

Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952) (surrender of lease by tenants to landlords for cash given capital gain (loss) treatment)

Commissioner v. Starr Bros., 204 F.2d 673 (2d Cir. 1953) (payment received by retail distributor from manufacturer for waiver of contract provision prohibiting manufacturer from selling to taxpayer's competitors *held* ordinary income)

General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953) (payments received by booking agent for canceling exclusive arrangement with singer *held* ordinary income)

Globe Corp. v. Commissioner, 20 T.C. 299 (1953) (under contract with U.S. Government, taxpayer manufactured and delivered military equipment in 1945; certain aspects of pricing were subject to negotiation after delivery, with price determined on "fair and equitable basis"; there were change orders, pricing dispute developed between taxpayer and Government contracting officer; dispute resolved and taxpayer paid in 1946; *held*, income taxable in 1946, when negotiations were completed)

Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954) (surrender of lease by tenants to landlords for cash given capital gain (loss) treatment)

Fisher v. Commissioner, 209 F.2d 513 (6th Cir. 1954) (sale of a right to collect previously accrued income yields ordinary income)

Lasky v. Commissioner, 22 T.C. 13 (1954) (sale of right to film royalties yields ordinary income)

Capitol Indemnity Ins. Co. v. Commissioner, 237 F.2d 901, 903 (7th Cir. 1956) (taxpayer may deduct amount paid to terminate burdensome and uneconomic contract)

Redford v, Commissioner, 28 T.C. 773 (1957) (basis in lots sold by taxpayer does not include secured, non-interest bearing, non-negotiable note for part of purchase price, payable from income and sale proceeds

Commissioner v. The Pittston Co., 282 F.2d 344 (2d Cir. 1958) (gain recognized from surrendering contract right is ordinary in character)

Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (if one retains an interest in transferred property, it suggests that the transfer does not alter the underlying investment, an indication that the ordinary income stream remains as such)

Commissioner v. Hansen, 360 U.S. 46 (1959) (debt found with virtual guarantee of payment but otherwise similar facts)

Metropolitan Building Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960) (leasehold interest is a capital asset)

Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960) (in granting favorable tax treatment to capital gains, one of Congress's purposes was to lessen the blow when gain from assets that have appreciated over time is recognized in a single year)

Campagna v. United States, 290 F.2d 682 (2d Cir. 1961) (in corporate liquidation, shareholder received mortgage valued at 20% of face amount but then received proceeds greater than this amount; excess *held* ordinary income)

Liftin v. Commissioner, 36 T.C. 909 (1961) (purchaser of notes at a discount could recover full basis before recognizing gain – open transaction)

Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962) (focused on the nature of contractual rights transferred, rather than on the recipients of those rights, in a departure from the extinguishment doctrine)

Miller v. Commissioner, 299 F.2d 706 (2d Cir. 1962) (wife of band leader Glen Miller denied capital gain on sale of production rights to movie about her husband)

Ayrton Metal Co., Inc. v. Commissioner, 299 F.2d 741 (2d Cir. 1962) (sale of share of profits from mining venture yields ordinary income)

Nelson Weaver Realty Corp. v. Commissioner, 307 F.2d 897 (5th Cir. 1962) (gain recognized on sale of a contract right is capital gain)

Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962) (sale of a right to collect previously accrued income yields ordinary income)

Monaghan v. Commissioner, 40 T.C. 680 (1963), *acq*. 1964 2 CB 6 (installment obligation may be allocated to certain assets in a larger sale; *see* Rev. Rul. 68-13, 1968-1 CB 195)

Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963) (if goodwill exists, capital gain or loss treatment is more likely)

Lowe v. Commissioner, 44 T.C. 363 (1965) (initial down payment that Seller received from stock sale *held* capital gain under *Arrowsmith* despite fact that Seller retained possession of stock and later retook control of corporation)

Maryland Coal & Coke Co. v. McGinness, 350 F.2d 293 (3d Cir. 1965) (sale of right to sell output of a mine yields ordinary income)

Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965) (taxpayer erroneously used open transaction method for a fixed-amount note, on accountant's advice; IRS disallowed open transaction method, and taxpayer elected installment method after the fact; *held*, IRS could not refuse to allow taxpayer to elect installment method (distinguishing *Pacific Nat. Co. v. Welch*, 304 U.S. 191 (1938), in which original method of accounting was permissible))

Bellamy v. Commissioner, 43 T.C. 487 (1965) (lack of taxpayer investment *held* to suggest ordinary income treatment)

Wingate v. Commissioner, 45 T.C. 489 (1966) (cash method taxpayer acquired mortgages at discount and made collections thereon; *held*, because mortgages were "speculative," taxpayer could recover his full basis before reporting any income)

Lozoff v. United States, 266 F. Supp. 966 (E.D. Wis. 1967) (sale of right to act as purchasing agent yields ordinary income)

Dorsey v. Commissioner, 49 T.C. 606 (1966) (corporate liquidation in which shareholders received contractual right to share of receipts from new automatic pinsetting equipment was open transaction, and amounts received were capital gain from liquidation; new and untried business model for bowling industry decisive (*Arrowsmith* not cited))

Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967) (stock-for cash-acquisition with covenant not to compete; values assigned to stock price and consideration for covenant in contract; *held*, in absence of proof of fraud, misrepresentation, duress or other reason to void contract, parties are bound by agreed form; only IRS may challenge)

Bankers Guarantee Title & Trust Co. v. United States, 418 F.2d 1084 (6th Cir. 1969) (if goodwill exists, capital gain or loss treatment is more likely)

Siple v. Commissioner, 54 T.C. 1 (1970) (purchasers of stock denied ordinary loss and allowed capital loss for payments to bank to redeem collateral pledged on behalf of corporation; payments to bank were part of the original cost of acquiring stock)

Schmidt v. Commissioner, 55 T.C. 335 (1970) (after partial liquidation, shareholder claimed long-term capital loss for excess of stock basis over the FMV of remaining assets; shareholder *held* not entitled to a loss until liquidation was complete)

Billy Rose's Diamond Horseshoe, Inc. v. Commissioner, 448 F.2d 549 (2d Cir. 1971) (release of contract right to repair leased premises not a sale)

MacDonald v. Commissioner, 55 T.C. 840 (1971) (license of new hardboard manufacturing process for royalty payments taxed as sale and open transaction; royalty payments treated as basis recovery and then capital gain; earlier licenses were different enough from license at issue so that FMV could not be based on history)

Estate of Shea v. Commissioner, 57 T.C. 15 (1971) (gain from disposition of a shipping charter gave rise to capital gain, partially because the FMV of the charter fluctuated with market forces)

Flower v. Commissioner, 61 T.C. 140 (1973) (sale of right to promote pharmaceutical products yields ordinary income)

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 Patentees)

Dennis v. Commissioner, 473 F.2d 274 (5th Cir. 1973) (securities issued tax-free under prior law in § 351 exchange *held* not to be part of open transaction and not boot)

In re Steen v. United States, 509 F.2d 1398 (9th Cir. 1975) (in sale of uranium mine for share of profits, Acquiror agreed to pay added purchase price if open state tax issue was favorably resolved; *held*, obligation to pay share of profits had FMV at time of sale, but state tax contingency payment had no FMV at that time because state tax issue was novel; sale treated as partly-closed transaction)

Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973) (cash method taxpayer sold apartment building for cash and contract obligation to make payments with bullet after 15 years; contract could be transferred only at substantial discount; based on history of § 1001 and enactment of § 453, "cash equivalent" test for gain realization applied by Tax Court rejected; transaction closed, and amount realized on sale measured by reference to FMV of contract)

Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978) (taxpayer's surrender of stock in satisfaction of warranty of corporation's net worth given to induce third party to invest in corporation was capital not ordinary loss; main reason for warranting corporation's net worth was to receive future option to buy more shares; warranty agreement was a sale transaction of which surrender of stock was an integrated part)

Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978) (offsetting put and call options on stock not treated as current sale of stock)

McShain v. Commissioner, 71 T.C. 998 (1979) (citing *Warren Jones*, 15-year nonrecourse note secured by 2d mortgage, received in sale of hotel, found not to have ascertainable FMV, and open transaction method allowed)

Estate of Wiggins v. Commissioner, 72 T.C. 701 (1979) (real estate developer sold lots for future payments under contract with no mortgage or other security and other contingencies; open transaction treatment allowed; taxpayer could recover basis before recognizing any taxable gain or income (including interest))

Monarch Cement Co. v. United States, 634 F.2d 484 (10th Cir. 1980) *aff'g* 458 F. Supp. 384 (D. Kan. 1978) (stock warrants issued in connection with a note was discount amortizable over the term of a loan; warrants valued at time of loan)

Campbell v. United States, 661 F.2d 209 (Ct. Cl. 1981) (taxpayer sold stock of corporation in exchange for cash and stock and securities of Acquiror; thereafter, Acquiror suffered reversals, and FMV of its stock and securities declined; *held*, sale transaction closed, and amount realized based on traded value of stock and securities at time of sale; hindsight not taken into account)

Foster v. Commissioner, 80 T.C. 34 (1983) (under open transaction method, amounts received for utility easements applied against basis of entire property)

Foote v. Commissioner, 81 T.C. 930 (1983) (amount paid to taxpayer by college in consideration of his relinquishment of tenure as professor was ordinary income)

Foy v. Commissioner, 84 T.C. 50 (1985) (taxpayer created a network of janitorial franchises and, for a share of revenue, guaranteed a certain level of sales. This right was a capital asset due to assumption of risk in guaranteeing sales and level of personal involvement)

Centel Communications v. Commissioner, 920 F.2d 1335 (7th Cir. 1990) (stock warrants issued to shareholders in recognition of loan guarantees were not transferred in connection with services under § 83; issuer not entitled to deduction, shareholders did not have ordinary income on exercise)

Nestlé Holdings, Inc. v. Commissioner, 94 T.C. 803 (1990) (accrual method Seller transferred the inventory of a discontinued business to Acquiror, in exchange for Acquiror preferred stock; *held*, preferred stock is "property" under § 1001(b), not an unconditional right to receive money in the future; Seller's amount realized based on stock FMV, not redemption price)

S*un Microsystems, Inc. v. Commissioner*, T.C. Memo 1993-467 (1993) (stock warrants issued as a purchase incentive were purchase price discounts; the warrants did not have to be capitalized)

T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993) (taxpayer may deduct amount paid solely to reduce or eliminate future costs)

Convergent Technologies v. Commissioner, T.C. Memo 1995-320 (1995) (stock warrants issued as a purchase incentive were purchase price discounts; the warrants did not have to be capitalized; warrants should be valued at exercise)

Computervision Int'l Corp. v. Commissioner, T.C. Memo 1996-131 (1996), *vacated on other grounds*, 164 F.3d 73 (1st Cir. 1999) (stock warrant issued as a purchase incentive qualified as a trade discount)

Wolff v. Commissioner, 148 F.3d 186 (2d Cir. 1998) (cited by IRS for proposition that extinguishment doctrine still valid, but facts occurred before passage of 1234A)

ACM Partnership v. Commissioner, T.C. Memo. 1997-115, *aff'd* 157 F.3d 231 (3d Cir. 1998) (installment sale contingent payment regulations resulting in loss not followed, because transaction disregarded as lacking economic substance)

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)

Nahey v. Commissioner, 111 T.C. 256 (1998), *aff'd*, 196 F.3d 866 (7th Cir. 1999) (taxpayer bought assets of a business that included a claim in a pending lawsuit involving lost income, and later settled suit at a gain. Court held settlement proceeds were ordinary income to buyer, rather than capital gain)

ASA Investerings Partnership v. Commissioner, T.C. Memo 1998-305, *aff'd* 201 F.3d 505 (D.C. Cir. 2000) (ACM-type contingent installment sale transaction established a debtor-creditor relationship, not a partnership)

Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (1999) (ACM-type contingent installment sale transaction disregarded as lacking economic substance and a sham)

Mann Const. Co. v. Commissioner, T.C. Memo. 1999-183 (no ordinary bad debt deduction under § 166 for contingent debt)

Custom Chrome Corp. v. Commissioner, 217 F.3d 1117 (9th Cir. 2000); *aff'g in part and rev'g in part*, T.C. Memo. 1998-317 (1998) (stock warrants issued in connection with a LBO transaction was discount amortizable over the term of a loan; warrants valued at time of loan)

Seagate Technology, Inc. v. Commissioner, T.C. Memo. 2000-361 (foreign subsidiary's sale of restricted third-party stock received as consideration for asset sale to third party treated as gain from sale of passive investment in stock, thus generating foreign personal holding company income under § 954(c); stock sale not treated as gain from the earlier asset sale since relation-back doctrine of *Arrowsmith* does not apply; open transaction treatment not applied to asset sale)

Bernice Patton Testamentary Trust v. United States, 87 AFTR 2d 1587 (Ct. Cl. 2001) (FMV of note at time of transaction was face value; installment sale not open transaction method was proper way to report income; subsequent change in note's FMV irrelevant)

Gladden v. Commissioner, 262 F.3d 851 (9th Cir. 2001) (taxpayer purchased land with no water rights but paid a premium because of expectation of obtaining water rights from a pending project; later, taxpayer sold the water rights but retained the land; held, taxpayer could apportion cost basis between land and water rights based on the premium; remanded for determination such basis apportionment or to determine whether determining such premium was "impractical or impossible")

Boca Investings Partnership v. United States, 314 F.2d 625 (D.C. Cir. 2003) (*ACM*-type contingent installment sale transaction disregarded, because no business purpose for partnership set up to make the sale)

Andantech, L.L.C., v. Commissioner, 331 F.3d 972, (D.C. Cir. 2003) (similar to *ASA Investerings*)

United States v. Culp, 99 AFTR 2d 2007-618 (M.D. Tenn. 2006) (in sale of accounting firm's consulting business, consulting partners received Acquiror stock in escrow, subject to forfeiture, and stock declined in value thereafter; *held*, partners taxed at closing on receipt of stock, not mere contingent interests in stock received later at depreciated value, because partners were contractually bound under *Danielson*; same transaction and same result as in *Berry*, *Fletcher*, *Bergbauer*, *Nackel*, *Fort* and *Hartman*)

Hightower v. Commissioner, T.C. Memo 2005-274, *aff'd unpub. op.*, 101 AFTR 2008-836 (9th Cir. 2008) (cash method taxpayer recognized gain on sale of stock on receipt of cash proceeds, even though validity of sale contested in later litigation)

United States v. Berry, 2008-2 USTC ¶ 50590 (D. N.H. 2008) (same transaction and same result as in *Culp*, *Fletcher*, *Bergbauer*, *Nackel*, *Fort* and *Hartman*; decision based on *Danielson*)

United States v. Fletcher, 562 F.3d 839 (7th Cir. 2009), *aff'g* 101 AFTR 2d 2008-588 (N.D. Ill. 2008) (same transaction and same result as in *Culp*, *Berry*, *Bergbauer*, *Nackel*, *Fort* and *Hartman*; decision on merits, not based on *Danielson*)

Fisher v. United States, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Ct. Fed. Cl. 2008) *aff'd without opinion*, 2009 WL 3241381 (Fed. Cir. 2009) (on demutualization of life insurance company, policyholder who retained his policy and received cash in lieu of stock for his equity interest could recover his full cost basis in his policy before recognizing gain; under open transaction principles, basis could not be allocated between policy and equity interest in mutual company, because there was no reasonable basis for allocation; default allocation of zero basis to equity interest, which would have led to gain on full amount of cash received, rejected; *see Dorrance* and *Reuben*, below)

Katz v. Commissioner, T.C. Memo. 2008-269 (after receiving stock in tax-free acquisitive reorganization, taxpayer entered into equity swap by buying put and selling call in stock and then sold stock and put for private annuity; purchaser sold stock; held, form of private annuity respected, and tax on gain deferred under Rev. Rul. 69-74)

United States v. Nackel, 686 F. Supp. 1008 (C.D. Cal. 2009) (same transaction and same result as in *Culp*, *Berry*, *Fletcher*, *Bergbauer*, *Fort* and *Hartman* with decision on merits; forfeiture of escrowed stock held unlikely)

Anschutz Co. v. Commissioner, 132 T.C. 78 (2010), *aff'd* 108 AFTR 2d 2011-7590 (10th Cir. 2011) (prepaid forward contract for sale of publicly-traded stock for cash (80% of stock's FMV) and agreement to lend the same stock treated as current sale of stock; Rev. Rul. 2003-7 distinguished; loan proceeds treated as amount realized; taxpayer retained rights to dividends and benefit of appreciation beyond fixed amount; IRS argued that these rights were additional sale price in closed transaction, but court treated them as additional price to be paid in open transaction; issue of contingent payments not dealt with in court of appeals opinion)

United States v. Bergbauer, 602 F.3d 569 (4th Cir. 2010) (same transaction and same result as in *Culp*, *Berry*, *Fletcher*, *Fort*, *Nackel* and *Hartman* with decision based mainly on *Danielson*)

United States v. Fort, 107 AFTR 2d 2011-1873 (11th Cir. 2011), *aff'g* 105 AFTR 2d 2010-2559 (D. Ga. 2008) (same transaction and same result as in *Culp*, *Berry*, *Fletcher*, *Bergbauer*, *Nackel* and *Hartman*, with decision on merits; forfeiture of escrowed stock found unlikely)

Hartman v. United States, 107 AFTR 2d 2011-2244 (Ct. Fed. Cl. May 13, 2011) (same transaction and same result as in *Culp*, *Berry*, *Fletcher*, *Bergbauer*, *Fort* and *Nackel*, with decision on merits (not based on *Danielson*), following *Fletcher* and *Fort*)

Samueli v. Commissioner, 661 F.3d 399 (9th Cir. 2011) (receipt of payment in fulfillment of payor's contractual obligation to deliver securities not "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of…a right or obligation…with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" under § 1234A; thus, receipt could be short-term, not long-term, capital gain from prior sale of securities)

Sollberger v. Commissioner, 691 F.3d 1119 (9th Cir. 2012) (same as *Samueli*)

Calloway v. Commissioner, 691 F.3d 1315 (11th Cir. 2012) (same as *Samueli*)

Peco Foods, Inc. v. Commissioner, T.C. Memo 2012-18 (Danielson rule to prevent Acquiror from subdividing portions of purchase price an allocated to buildings in the agreement among components of the buildings)

Dorrance v. United States, 877 F. Supp. 2d 827 (D. Az. 2012) (same situation as in *Fisher*; summary judgment denied to policy holder; open transaction treatment rejected because FMV of stock and life insurance policy could be determined; *Fisher* not followed; commentary critical of *Fisher* cited); 111 AFTR 2d 2013-1280 (2013) (taxpayer's basis in equity interest in mutual company computed based on FMV of new stock company stock and other factors)

Reuben v. United States, 111 AFTR 2d 2013-620 (C.D. Cal. 2013) (situation similar to *Fisher*; except that taxpayer elected to receive stock for his equity interest in mutual company and sold the stock later; court declines to follow *Fisher*; taxpayer's motion for summary judgment denied, because open transaction method limited to transactions that will "close" later, whereas basis is irrelevant when life insurance policy closes upon death of insured, and result is windfall to taxpayer)

Revenue Rulings and Notices

Rev. Rul. 58-402, 1958-2 CB 15 (contracts and claims to receive indefinite amounts, such as those received in corporate liquidation, must be valued for tax purposes except in rare and extraordinary cases)

Rev. Rul. 68-13, 1968-1 CB 195 (installment obligation may be allocated to certain assets in a larger sale; *see Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq*. 1964 2 CB 6)

Rev. Rul. 69-74, 1969-1 CB 43 (in sale of property by individual at a gain for private annuity on seller's life, gain realized on difference between present value of annuity, based on annuitant's life expectancy, and property basis; gain deferred and taxed ratably over life expectancy; to be reversed by Prop. Reg. § 1.1001-1(j) (2006))

Rev. Rul. 76-527, 1975-2 CB 30 (no sale, and so no capital gain, upon release of a right to heat a building, because right was extinguished rather than "passed" to another party)

Rev. Rul. 77-56, 1977-1 CB 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. 77-414, 1977-2 CB 299 (under open transaction method, proceeds of sale of development rights to agricultural property applied to reduce basis of land and improvements, allocated based on relative amounts of reduction in FMV of land and improvements)

Rev. Rul. 77-294, 1977-2 CB 173, *revoking* Rev. Rul. 68-246, 1968-1 CB 198 (installment sale agreement changed in year of sale to place purchase price in escrow without substantial restriction on seller's right to receive escrowed funds; installment method not available)

Rev. Rul. 79-278, 1979-2 CB 302 (Acquiror bought Target stock from Seller and sold it at short-term capital loss; Seller paid damages to Target under court-ordered settlement for securities law violations; under *Arrowsmith*, payment is short-term capital gain to Acquiror, reported in year court approves settlement)

Rev. Rul. 85-87, 1985-1 CB 268 (sale of stock at a loss coupled with sale of "in-the-money" put on stock; put treated as contract to acquire the stock and caused loss to be disallowed under wash sale rules)

Rev. Rul. 87-63, 1987-2 CB 210 (payments under commodity trading franchise license agreement not subject to § 1253(d) but deductible upon economic performance)

Rev. Rul. 88-24, 1988-1 CB 306 (on sale of franchise business subject to rights of original franchisee, buyer may amortize amount allocable, under § 1060, to purchased franchise rights, as provided in § 1253(d), even though transaction is sale of a capital asset)

Notice 90-56, 1990-2 CB 344 (installment sale regulations to be revised to prevent inappropriate deferral of basis recovery)

Rev. Rul. 2003-7, 2003-1 CB 363 (receipt of cash for promise to deliver shares of stock in the future, with number of shares dependent on FMV at that time and pledge of shares to secure promise, not treated as current sale of stock)

Rev. Rul. 2002-31, 2002-1 CB 1023 (convertible zero-coupon debt with contingent interest – payable if instrument increases in FMV – results in interest deductions under "contingent bond method"; § 163(l) (disallowing deductions for interest payable in stock) not applicable; § 249 (disallowing deduction for redemption premium based on conversion feature) not applicable to periodic interest deductions; *see also* Notice 2002-36, 2002-1 CB 1029)

Notice 2008-2, 2008-1 CB 252 (request for comments as to whether parties to a prepaid forward contracts, exchange traded notes and other financial instruments not classified as debt should be required to accrue income/expense during the term of the transaction, and related issues)

Chief Counsel Guidance

GCM 37073 (Mar. 31, 1977) and cases cited therein (accrual method contractor taxed currently on cash transferred to custodian pending contractor's performance under contract if contractor has investment power or power to substitute securities for cash—"dominion and control" theory, not "constructive receipt" or "economic benefit")

PLR 8217183 (Jan. 29, 1982), *supplemented*, PLR 8221081 (Feb. 25, 1982) (parent sold stock of subsidiary which had a contingent claim against it; buyer agreed to pay additional cash if claim proved to be less than specified amount; based on cash sale price and estimate of additional payment, total consideration was less than parent's stock basis; IRS rules that, if transaction is "closed," parent may claim loss in year of sale based on cash price plus FMV of additional payment, but, if transaction is open, loss may not be realized until later)

PLR 8537049 (June 17, 1985) (income projections used as alternative method to recover basis in installment sale)
PLR 8621023 (Feb. 19, 1986) (income projections used as alternative method to recover basis in installment sale)
PLR 8629038 (Apr. 18, 1986) and authorities cited therein (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 (Aug. 8, 1986) (similar to PLR 8629038)
TAM 9737001 (May 23, 1997) (warrants issued to cable companies in connection with affiliation agreements providing channel access warrants were not granted in connection with services, but as an inducement to obtain more channel access; § 83 does not apply)
PLR 9743034 (July 28, 1997) and PLR 9743035 (July 28, 1997), *revoking* PLR 9211029 (Dec. 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 9840001 (Oct. 2, 1998) (contingent payment right not debt where obligation to make payments entirely dependent on ability to collect payment from third parties with very poor credit ratings, and payments due only on amount remaining after collection costs and servicing fees)
PLR 984006 (Oct. 16, 1998) (allows ordinary deduction for public utility that buys out contract right of PURPA "qualified facility" but mentions neither 1234A or extinguishment doctrine)
PLR 19913032 (April 5, 1999) (allows ordinary deduction for public utility that buys out contract right of PURPA qualified facility, but mentions neither 1234A or extinguishment doctrine)
FSA 199941001 (Feb. 2, 1999) (Seller using the FMV of contingent payment right calculated gain correctly but maximum amount might have been appropriate)
TAM 200043013 (Oct. 30, 2000) (warrants issued to lending bank in bankruptcy reorganization of borrower not transferred in connection with services performed by bank; if warrants have value at time of issuance, there is OID on loan deductible over life of loan)
PLR 200045019 (Aug. 10, 2000) (receipt of payment to terminate a rent controlled lease capital gain on sale of leasehold interest)
TAM 200049009 (Aug. 9, 2000) (owner of PURPA qualified facility receives ordinary income from sale to public utility of right to sell its output — adopts extinguishment doctrine)
PLR 200051033 (Sept. 25, 2000) (allows ordinary deduction for public utility that buys out contract right of PURPA qualified facility but mentions neither 1234A or extinguishment doctrine)
PLR 200051035 (Sept. 26, 2000) (similar to PLR 200051033)
PLR 200052010 (Jan. 2, 2001) (amounts paid to terminate burdensome fuel transportation treated as ordinary loss, not capital loss under § 1234A)
PLR 200130002 (July 27, 2001) (sale of rights to license and distribute popular television talk show was sale of capital asset)

PLR 200215037 (Jan. 14, 2002) (qualified facility's bundle of contract rights under PURPA is a capital asset in part because the profit or loss derived therefrom depends on the fluctuating market price of electricity)

PLR 200345020 (Nov. 7, 2003) (installment sale with contingent purchase price approved for alternative accelerated basis recovery)

TAM 200346007 (Nov. 14, 2003) (sale-leaseback at less than FMV can qualify as sale, but basis will be adjusted to FMV; resembles installment sale)

TAM 200427025 (Dec. 9, 2003) (receipt of payment to cancel contract for purchase of electric power ordinary income; § 1234A not applicable, because payment was substitute for ordinary income that taxpayer would have realized from sales)

CCA 200423028 (March 30, 2004) (lottery winner sold winning ticket for contingent installment note with payments based in part on investment of lottery proceeds as directed by seller; installment method allowed)

LAFA 20042304F (June 4, 2004) (taxpayer issued its warrants to customer as part of customer's agreement to allow taxpayer to operate customer's data center; no income exclusion or deduction for the warrants allowed; *Sun Microsystems* and *Convergent Technologies* distinguished, because (1) customer exercised the warrants, (2) warrants not tied to any quantity of services purchased by customer, and (3) no intent documented to treat issuance of warrants as a discount)

TAM 200452033 (Sept. 27, 2004) (amounts received on policy holder's termination of life insurance policies taxed as ordinary income to extent attributable to inside buildup; § 1234A not applicable)

PLR 200603017 (Oct. 7, 2005) (earn-out payment with no cap on stock sale; under installment method, IRS grants alternative basis recovery based on estimated earn-out payments)

Generic Legal Mem. 2007-4 ("backwards" contingent sale: Seller receives $1,600 at closing and agrees to deliver a number of shares of stock contingent on traded price on a future date; Seller pledged maximum number of shares to escrow, which loaned them to Acquiror; transaction treated as immediate sale of Seller's stock; Rev. Rul. 2003-7, 2003-1 CB 363, distinguished because of securities loan)

LAFA 20080101F (Dec. 3 2007) (purported sale for contingent purchase price not a sale for tax purposes under economic substance doctrine, but, if a sale, installment method does not apply separately to each class of assets under § 1060 (citing earlier version of this outline); imputed interest under § 483 must be computed; and deferral charge applies)

PLR 201027035 (Mar. 31, 2010) (as part of consideration in § 338(h)(10) stock sale, Seller received right to a percentage of tax benefit New T obtained from stepped-up basis in deemed purchased assets; Seller assigned part of its rights to Y, and New T settled its obligations for a fixed cash payment to Y; *ruled*, New T did not realize cancellation-of-debt income)

PLR 201043009 (July 21, 2010) (same as PLRs 201043010 – 201043014) (foreign government expropriated stock in corporation through series of steps culminating in squeeze-out of taxpayers' stock; taxpayers received cash for their stock in amount less than basis. taxpayers sued in foreign country court to obtain return of their stock but represented that they had "no reasonable prospect of recovering" their stock in court; *ruled*, pending lawsuit does not prevent loss from being recognized at time of expropriation)

PLR 201203003 (Oct. 11, 2011) (agreement to purchase electric power capital asset; capital gain or loss generated upon sale)

TAM 201214021 (Jan. 10, 2012) (open transaction method not available on exercise of cash-settled puts relating to stock)

Commentary

D. Schenk, "*Arrowsmith* and its Progeny: Tax Characterization by Reference to Past Events," 33 Rutgers L. Rev. 317 (1980)

A. Goldberg, "Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980," 34 Tax Lawyer 605 (1981)

J. Lee & M. Bader, "Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income," 12 J. Corp. L. 137 (1987)

S. Land, "Contingent Payments and the Time Value of Money," 40 Tax Lawyer 237 (1987)

M. Schler, "Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More," 43 Tax L. Rev. 605 (1988)

Ass'n of the Bar of the City of New York, Committee on Personal Income Tax, "Report on the Taxation of Escrow Accounts," 90 Tax Notes Today 264-43 (Dec. 31, 1990)

N.Y.S. Bar Ass'n Tax Section, "Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed by Section 468B(g) of the Internal Revenue Code," 92 TNT 156-31 (July 31, 1992)

K. Keyes, "The Treatment of Contingent Consideration in Asset Acquisitions," 50 N.Y.U. Inst. Fed. Tax'n § 21 (1992)

R. Wootton, "Mrs. Logan's Ghost: The Open Transaction Doctrine Today," 71 TAXES 725 (1993)

D. Geier, The Myth of the Matching Principle as a Tax Value, 15 American Journal of Tax Policy 17 (1998)

L. Sheppard, "Installment Method Repealed for Whom?" 86 Tax Notes 8 (Jan. 3, 2000)

K. Blanchard & T. Haythe, "Installment Method Repeal Makes No Sense At All," 86 Tax Notes 429 (Jan. 17, 2000)

Statement of Pamela Olson on Behalf of the American Bar Association Section of Taxation Before the House Subcommittee on Small Business of the U.S. House of Representatives on the Subject of Small Business Use of the Cash Method of Accounting and Repeal of Installment Method of Accounting, April 5, 2000 (2000 TNT 68-26)

R. Bailine, "KPMG Asks for Guidance on Contingent Payments Following a Stock Purchase Treated As an Asset Purchase," 2000 Tax Notes Today 97-19 (May 18, 2000)

Corporate Acquisition Ideas, "IRS Issues New Guidance on the Use of the Installment Sale Method of Accounting" Corporate Acquisitions, Mergers, and Divestitures, June 2000

R. Flinn, "Does Installment Sale Rule Change Make Stock Sales a More Attractive Means of Structuring Sale of Smaller C Corporations?" 78 TAXES 31 (July 2000)

E. Sair, et. al., "Treatment of Contingent Obligations in Stock or Asset Sales Uncertain After Repeal of Installment Method of Reporting for Accrual Method Taxpayers," J. Corp. Tax'n 203 (Autumn 2000)

E. Seago, "A Modest Proposal Regarding the Matching Principle," 90 Tax Notes 1855 (2001)

D. Geier, "Why the Matching Principle Has No Place in the Income Tax World," 91 Tax Notes 343 (2001)

D. Halperin, "Financial Accounting Is Not Always the Best Measure of Taxable Income," 92 Tax Notes 131 (2001)

M. Baillif, "Sales Price Adjustments: The Continuing Conundrum," 57 Tax Lawyer 571 (2004)

M.A. Stevens, "The Tax Treatment of Contingent Options," 102 Tax Notes 525 (2004)

J. Cummings, "TAM 200427025 Raises Questions on How Little-Known Statutory Change Affects Abandonments of Property," Corporate Tax Insights on Checkpoint (July 13, 2004)

M. Farber, "Equity, Debt, NOT – The Tax Treatment of Non-Debt Open Transactions," 60 Tax Lawyer 635 (Spring 2007)

R. Beeman & Y. Keinan, "The Tax Treatment of Exchange Traded Notes: Here We Go Again," 119 Tax Notes 485 (May 5, 2008)

K. Keyes, "The Treatment of Contingent Consideration in Asset Acquisitions," 4 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 41

K. Blanchard, "The Tax Treatment of Earnouts in Business Acquisitions," 4 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 42

D. Raab, "Traps and Opportunities Involving Contingent Purchase Price Acquisitions: Why Does Something So Simple Have to Be So Complicated?" 4 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 43

W. Skinner, "Taxation of Earn-Outs in Public Company Acquisitions," 4 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 43A

D. Halperin, "2009 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Rethinking the Advantage of Tax Deferral," 62 Tax Lawyer 535 (2009)

P. Galindo, Note: "Revisiting the 'Open Transaction' Doctrine: Exploring Gain Potential and the Importance of Categorizing Amounts Realized, "63 Tax Lawyer 221 (2009)

D. Schaaf, R. Wellen & E. Mayshar, "Contingent Consideration and Contingent Liabilities in Taxable Asset Acquisitions," 77 N.Y.U. Inst. Fed. Tax'n Part I § 2 (2009)

R. Willens, "Calgene/Abraxis: An Open Transaction?" 128 Tax Notes 865 (Aug. 23, 2010)

V. Gulbis, "Taxation of Earn-Out Payments in Taxable Acquisitions," 87 Practical Tax Strategies/Taxation for Accountants No. 1 (July 2011)

ABA Section of Tax'n, "Options for Tax Reform in the Financial Transactions Provisions of the Internal Revenue Code (Dec. 2, 2011)

R. Willens, "E&Y Partner Constructively Received Shares of Cap Gemini," 137 Tax Notes 793 (Nov. 12, 2012)

R. Jacobus, Dodging the Danielson Rule: Hartman v. United States, 138 Tax Notes 715 (Feb. 11, 2013)

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

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II-845 n2 (1986) (§ 468B(g) intended to "reverse the finding in Rev. Rul. 71-119," which implied no current tax on escrow income)

Proposed Regulations

Prop. Reg. § 1.468B-8 (income earned on "contingent at-closing escrows" on sales of trade or business taxed to purchaser who provided the funds, regardless of which party is the owner under general tax principles)

Prop. Reg. § 1.468B-9 (income earned on "disputed ownership funds" under court jurisdiction taxed on the fund as a separate entity like a "qualified settlement fund" (*see also* Reg. § 1.468B-1, allowing grantor of qualified settlement fund to elect to be taxed on fund income))

Court Decisions

Bonham v. Commissioner, 89 F.2d 725 (8th Cir. 1937) (Acquiror stock received by Seller in taxable exchange and transferred to escrow to secure Seller's obligations; stock would be sold and applied to compensate Acquiror for Seller breach; *held*, stock taxable as sale proceeds to Seller despite escrow)

Chaplin v. Commissioner, 136 F.2d 298 (9th Cir. 1943) (filmmaker received stock placed in escrow pending his future delivery of five photoplays, but filmmaker had rights to vote and to receive dividends; *held*, stock taxable to filmmaker despite escrow)

Brown v. Commissioner, 10 B.T.A. 1036 (1928) (Seller, shareholder-employee of Target, wishing to induce Acquiror to buy remaining Target stock from estate, promised to pay Acquiror part of back salary Target might pay to Seller; payment held reduction in Acquiror's purchase price for Target stock, not income to Acquiror)

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) (Target recognizes no income when Acquiror places funds in escrow against possible breach of warranty for undisclosed corporate liabilities)

Oden v. Commissioner, 56 T.C. 569 (1971) (deposit of funds into escrow by purchaser of property results in constructive receipt by seller, if seller's right to receive the funds is not subject to substantial restriction other than time of payment)

Freedom Newspapers, Inc. v. Commissioner, T.C. Memo 1977-429 (Acquiror purchased four newspapers, including one unwanted newspaper; broker agreed to find buyer for unwanted newspaper or pay cash amount; buyer not found, and cash payment made by broker; unwanted newspaper sold later; cash payment *held* reduction in purchase price for unwanted newspaper, not liquidated damages for failure to sell the unwanted newspaper, thus reduced capital loss on sale of unwanted newspaper, not ordinary income to purchaser)

Stiles v. Commissioner, 69 T.C. 558 (1978), acq. 1978-2 CB 3 (deposit of funds into escrow by purchaser of property does not result in constructive receipt to seller, if seller's right to escrowed funds is subject to substantial restriction or condition)

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 § 468B(g))

Ahadpour v. Commissioner, T. C. Memo 1999-9 (1999), *acq. in result only*, AOD 2000-002, 2000-1 CB ix (escrow payments received by seller not taxable while escrow period remained open because seller obligated to repay amounts if escrow did not close; IRS acquiesced in result only that escrow payments received by seller not taxable; for non-real estate dealers, escrow payments not treated as deposits)

Revenue Rulings

Rev. Rul. 77-294, 1977-2 CB 173 (escrow imposing substantial restriction on seller's right to receive sales proceeds eligible for installment method)

Rev. Rul. 79-91, 1979-1 CB 179 (six-year payment schedule is not a substantial restriction on seller's right to receive sale proceeds; installment method not available on sale)

Rev. Rul. 87-127, 1987-2, CB 156 (income earned by pre-need funeral trust generally taxed to purchaser of pre-need funeral; *see* § 685)

Rev. Rul. 92-51, 1992-2 CB 102, *obsoleting* Rev. Rul. 71-119, 1971-1 CB 163 (court controlled fund not taxable grantor trust), Rev. Rul. 70-567, 1970-2 CB 133 (interest accumulated in escrow taxable upon distribution) and Rev. Rul. 64-131, 1964-1 CB Part 1 485 (third situation: income on funds held in anticipation of settling litigation taxable upon distribution)

Chief Counsel Guidance

GCM 37073 (March 31, 1977) (accrual method contractor taxed currently on cash transferred to custodian pending contractor's performance under contract if contractor has investment power or power to substitute securities for cash—"dominion and control" theory, not "constructive receipt" or "economic benefit")

PLR 9243033 (July 24, 1992) (income on state-established escrow (on behalf of several counties) pending court decision on validity of imposition of use tax; *held*, taxable)

PLR 9228020 (Apr. 10, 1992) (income on SEC-controlled escrow accounts; *held*, not taxable because accounts established before effective date of § 468B(g))

PLR 199949041 (Sept. 13, 1999) (contingent payment asset sale under installment method; IRS allows alternative basis recovery under Temp. Reg. § 15a.453-1 (c)(7))

PLR 200521007 (Feb. 25, 2005) (on S corporation asset sale, part of sale price escrowed against seller indemnity for breach of warranty, covenant or representation; installment method not used, because accountant advised not available; IRS rules installment method available because of substantial conditions in escrow, and consents to revocation of election out of installment method)

PLR 200714007 (Jan. 8, 2007) (IRS "will not challenge" application by taxpayer of Prop. Reg. § 1.468B-9 to escrow established before effective date of final regulation based thereon)

Commentary

R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981)

Report on the Taxation of Escrow Accounts, Committee on Personal Income Tax of the Bar of the City of New York, Dec. 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 Association 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)

J.L. Cummings, "The tax-free cash-out reorganization—*Eugene A. Fisher et al. v. U.S.* (Ct. Fed. Cl. 8/6/2008) 102 AFTR 2d ¶ 2008-5150," Commentary from: Corporate Tax Insights on Checkpoint (Aug. 11, 2008)

R. Willens, "With '*Fisher*' Ruling, Open Transaction Doctrine Lives," 162 DTR J-1 (Aug. 21, 2008)

S. Olson, "Chuck vs. Goliath: Basis of Stock Received in Demutualization of Mutual Insurance Companies," 9 Houston Bus. & Tax L.J. 360 (2009)

Taxable Asset Acquisitions – Contingent Liabilities and Indemnities

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 in year with or within which ends year in which income is includible by employee; *see* § 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)

Current Regulations and Preamble

Reg. §§ 1.263(a)-4 and 1.263(a)-5 (expenditures to acquire or create intangibles, including a trade or business)

TD 9107 (Dec. 31, 2003) (preamble adopting Reg. §§ 1.263(a)-4 and 1.263(a)-5

Reg. § 1.338-4(d) (for ADSP purposes, contingent liabilities taken into account as though there had been an actual asset sale)

Reg. § 1.338-5(b)(2)(iii) Example 2 (assumed environmental liability)

Reg. § 1.338-5(e)(2) (for AGUB purposes, contingent liabilities taken into account as though there had been an actual asset sale)

Reg. § 1.338-6(c)(5) (special treatment of nonqualified funds transferred in connection with sales of nuclear power plants; buyer may elect to treat qualified fund as a corporation whose stock is purchased with a § 338(h)(10) election)

Reg. § 1.338-11 (application of § 338 to taxable asset acquisitions of insurance companies, including "assumption-reinsurance" transactions)

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 § 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 assumption of liability incurred on acquisition of asset, if liability is not included in asset basis)

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

Reg. §§ 1.1374-4(b)(2), (h) (treatment of offsetting gain and deduction relating to assumption of Target's contingent liability in a disposition of target's property followed by S election)

Reg. § 1.1502-76(b)(4) Example (5) (if Target 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)

TD 9376 (Jan. 16, 2008) (preamble dealing with § 332 liquidations suggests that, in a sale of a business, if the purchaser assumes an obligation to provide goods or services that as to which the seller deferred income, any amount paid to the purchaser would be taxable income)

Proposed Regulations and Possible Future Guidance

Prop. Reg. § 1.263(a)-2(d)(3)(ii)(D) (employee compensation and overhead to acquire tangible property not required to be capitalized)

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)

Office of Tax Policy and Internal Revenue Service Priority Guidance Plan 2014-2015 (Aug. 26, 2014), Tax Accounting ¶¶ 12 (section 451 regulations on advance payments for goods and services, including gift cards), 22 (deferred revenue in taxable asset sales and acquisitions)

Regulations Applicable to Qualified Stock Purchases On or Before January 5, 2000

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 §§ 338(g) and 338(h)(10) (buyer side))

Reg. § 1.338-1T(a)(2) (deemed asset sale taxed as assumption reinsurance transaction)

Reg. § 1.338(b)-3T(b) (definition of "contingent amount")

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 §§ 338(g) and 338(h)(10), in determining AGUB and asset basis; reductions of consideration or liabilities taken into account when the reduction "occurs")

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

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

Reg. § 1.338(b)-3T(h) (contingent payments and contingent liabilities under § 338(h)(10) (seller side))
Reg. § 1.338(b)-3T(j) Example (1)(iv)-(vi) (contingent liabilities under § 338(g), buyer side (AGUB))
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")
Reg. § 1.1060-1T(f)(2) (FMV limitation for allocations to asset classes determined on acquisition date and not adjusted later)

Court Decisions

Crane v. Commissioner, 331 U.S. 1 (1937) (amount realized on sale of property includes mortgage to which property is subject; *see especially* footnote 6, stating that Commissioner had limited the amount realized to unpaid principal, because unpaid interest "was a deductible item.")
Cooledge v. Commissioner, 40 B.T.A. 1325 (1939), acq. 1940-1 CB 2 (cash basis Seller's amount realized on sale of real property *held* to include Acquiror'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; law changed by § 164(d))
Flood v. United States, 133 F.2d 173 (1st Cir. 1943) (payments by partners to former partnership employees deductible, even though partnership business had been sold)
Rogers v. Commissioner, 5 T.C. 818 (1945) (real property Seller covenanted that property tax had been paid; state law change resulted in additional pre-sale tax; Acquiror paid tax, and Seller defaulted on covenant; *held*, Acquiror allowed bad debt deduction and not required to add tax to property basis)
Oxford Paper Co. v. United States, 86 F. Supp. 366 (S.D.N.Y. 1949), (lessee transferred land and a building to Acquiror, which assumed lessee's obligation on water rights lease; Acquiror reported FMV of land and building as income when received, taxpayer's depreciable cost basis in building *held* limited to allocable portion of contingent liability assumed, which was not shown; summary judgment denied to both taxpayer and Government)
Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (after liquidation, a judgment was rendered against liquidated corporation, and the shareholders had to pay the judgment; *held*, because shareholders recognized capital gain on liquidation, payments of the judgment were treated as capital loss when made)
Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d Cir. 1952), *rev'g* 15 T.C. 361, *nonacq.* 1951-1 CB 4 (same transaction as in 86 F. Supp. 366; 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) (Seller 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 to Acquiror and liquidation of Target, 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 Target stock and payment by Target, so that Acquiror could deduct interest accrued after liquidation of Target; prior interest was part of cost of Target's assets acquired in liquidation)

Denver & Rio Grande Western R.R. v. Commissioner, 32 T.C. 43 (1959), *aff'd on other issues* 279 F.2d 368 (10th Cir. 1960) (railroad's basis sidings did not include part of cost paid by shippers for shipping services)

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 Acquiror to assume the liability; in dictum, court states that Acquiror may have taxable income on deemed payment; *see* Rev. Rul. 68-112)

Rees Blow Pipe Manufacturing Co. v. Commissioner, 41 T.C. 598 (1964), *aff'd per curiam* 342 F.2d 990 (9th Cir. 1965), *nonacq*. 1966-2 CB 8 (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)

Columbus and Greenville Ry. v. Commissioner, 42 T.C. 834, 849 (1964) *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966) (acquired property subject to mortgage on which another party was also liable; taxpayer's liability was absolved without payment in consideration of contingent agreement to sell property to the other obligor for "the amount which the present owners have put into the property;" no part of mortgage added to property basis for depreciation purposes)

F. & D. Rentals, Inc. v. Commissioner, 365 F.2d 34 (7th Cir. 1966), *aff'g* 44 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 § 404(a)(1) when made)

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

United States v. Shelby Oil Co., 394 U.S. 678 (1969) (taxpayer realized income from natural gas production and claimed percentage depletion deduction; later taxpayer refunded a portion of the income; *held*, deduction for refund was reduced by percentage depletion)

Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 904 (1971) (short-swing insider trading profit payment under § 16(b) of Securities Exchange Act of 1934 deductible as capital loss, not ordinary deduction, because profit was taxed as capital gain; same result in *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973), *Cummings v. Commissioner*, 506 F.2d 449 (2d Cir. 1974), and *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976))

Lemery v. Commissioner, 52 T.C. 367 (1969), *aff'd per curiam*, 451 F.2d 173 (9th Cir. 1971) (covenant not to compete from seller of motel not amortizable, inter alia, because obligation to pay for covenant was contingent on net profits of motel)

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 Target, shareholders paid cash to reimburse buyer for cost of obligation to Target 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) (Acquiror bought Seller stock, and Seller liquidated under old § 334(b)(2); litigation on cargo lost at sea pending against Seller, but acquisition price for Seller stock not reduced, because of insurance coverage and early success in litigation; Acquiror later made payment to settle claim; payment *held* not deductible but capitalized in cost of Seller property; fact that "liability was contingent and unliquidated … is of no significance")

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

Of Course Inc. v. Commissioner, 499 F.2d 754 (1974) (corporation's legal fees directly related to sale of capital assets under § 337 liquidation must be capitalized)

Denver & Rio Grande Western R.R. v. United States, 505 F.2d 1266, (Ct. Cl. 1974) (mining company paid cost of rail line to its mine; railroad owned the line and was to repay cost out of future revenue; railroad's basis in line includes only amounts actually paid; contingent obligations excluded from basis)

Bresler v. Commissioner, 65 T.C. 182 (1975) (antitrust settlement received by shareholder of S corporation constituted ordinary income to the extent it compensated for ordinary losses reported upon sale of corporate assets in prior year)

Smith v. Commissioner, 67 T.C. 570 (1976) (capital loss treatment imposed on seller of unregistered stock for payments he made in class action settlement of alleged Securities Act violations arising from the sale)

Benedict Oil Co. v. United States, 582 F.2d 544 (10th Cir. 1978) (business expense deduction denied to corporation for legal and accounting expenses incurred in sale of assets during plan of complete liquidation under § 337)

Hyde v. Commissioner, 69 T.C. 300 (1978) (taxpayer acquired property by quitclaim, subject to mortgages in foreclosure proceedings, then redeemed property; taxes and interest accruing after quitclaim *held* deductible, pre-quitclaim taxes and interest capitalized; redemption fee deductible as interest)

Abdalla v. Commissioner, 69 T.C. 697 (1978) (taxpayer denied reduction of gain recognized on liquidation of the corporations for Federal income tax deficiencies owed by corporations and assumed by taxpayer as transferee; losses to be recognized later, when tax payments made)

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.*, 1986-2 CB 1 (cash basis Seller of assets treated as paying payables assumed by Acquiror, because Acquiror assumed liabilities instead of paying more cash; Acquiror increases basis in assets by same amount; *see* AOD 1986-027)

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

Boothe v. Commissioner, 82 T.C. 804 (1984), *rev'd on other grounds*, 768 F.2d 1140 (9th Cir. 1985) (payments made by Seller on breach of warranty claim by Acquiror related back to sale of real property rights under *Arrowsmith*; Seller entitled to capital loss)

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 Acquiror's assuming Seller's obligation to lessee to repair roof)

United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) (casino company's liability to pay jackpot on progressive slot machines fixed by state regulation requiring payment, even before a player wins – deductible under "all events" test under § 162(a); *but see* § 461(h), enacted later)

Waddell v. Commissioner, 86 T.C. 848, 898-912 (1986), *aff'd per curiam*, 841 F.2d 264, (9th Cir. 1988) (contingent note payable out of operating proceeds not included in property basis where face amount of note exceeds property FMV and payment is speculative)

United States v. General Dynamics Corp., 481 U.S. 239 (1987) (employee medical claims not deductible under "all events" test before claims filed)

Transamerica Corp. v. United States, 999 F.2d 1362 (9th Cir. 1993), *rev'g* 670 F. Supp. 1454 (N.D. Cal. 1986) (under income forecast method, cost basis of film includes estimated "participations" and "residuals" payable to actors, writers, producers, etc. – *but see* § 167(g)(1)(B), enacted later (basis includes only costs that satisfy economic performance test))

Mitchell v. Commissioner, T.C. Memo 1994-237 (taxpayer who indirectly purchases stock from savings and loan in violation of Federal Home Loan Bank Board's regulations, couldn't currently deduct the amount he paid to savings and loan to compensate it for lost tax benefits resulting from the transaction; payment was made to protect capital asset and so is included in stock basis)

Merkel v. Commissioner, 192 F.3d 844 (9th Cir.1999) (contingent liabilities not taken into account under § 108 insolvency exception, because borrower was not more-likely-than-not to be called upon to pay them; discounting liability by probability of occurrence rejected)

Exxon Mobil Corp. v. Commissioner, 114 T.C. 20 (2000) (dismantlement, removal, and restoration costs relating to oil wells and to production equipment and facilities not sufficiently definite and fixed to be accruable under the all-events test of § 1.461-1(a)(2))

Chrysler Corporation v. Commissioner, T.C. Memo 2000-283 (costs of satisfying automobile warranties not sufficiently definite and fixed to be accruable under all-events test of § 1.461-1(a)(2) at time of sale of automobiles dealers)

United Dairy Farmers, Inc. v. Commissioner, 267 F.3d 510 (6th Cir. 2001) (corporation's environmental clean-up costs for contaminated properties were capital, not currently deductible expenses since contamination already existed at time of purchase)

Illinois Tool Works, Inc. v. Commissioner, **117** T.C. 4 (2001), *aff'd* 355 F.3d 997 (7th Cir. 2004) (Acquiror of Target's assets assumed liability for and paid Target's patent infringement liability; even though unexpected, payments *held* not deductible, but added to Target's asset basis when made; Webb followed)

Putnam-Greene Financial Corp. v. United States, 308 F. Supp. 2d 1374 (M.D. Ga. 2004) (litigation expenses incurred by corporation in defending against suits by minority shareholders of corporation it acquired were deductible as a matter of law, but treatment of other shareholder litigation costs submitted to jury)

United States v. Maginnis, 93 AFTR 2d 2004-660 (9th Cir. 2004) (lump sum received for assignment of state lottery installment payments *held* ordinary income; right to receive lottery payments not a capital asset under "substitute for ordinary income" doctrine)

Daishowa-Marubeni International Ltd. v. Canada, 2013 SCC 29 (2013) (assumption by Acquiror of timberland of reforestation obligation not added to Seller's amount realized on sale, because obligation was not a distinct liability but a future cost that depresses FMV of property)

AmerGen Energy Co. LLC v. United States, 112 AFTR 2d 2013-6376 (Ct. Fed. Cl. 2013) (appeal pending) (Acquiror of nuclear power station may not add assumed liability for decommissioning expense to its depreciable basis; economic performance requirement for accrual, in § 461(h) and regulations thereunder, apply to Acquiror's asset basis as well as to deductions; treatment of funds in trust to provide for decommissioning, transferred to Acquiror, not addressed)

United States v. ConocoPhillips Co., 744 F.3d 1199 (10th Cir. 2014) (closing agreement allowing fixed amount of deductions for future dismantling, removal and restoration costs related to Trans-Alaska Pipeline limited to taxpayers and their "successors in interest," which did not include purchasers of interests from unaffiliated sellers; basis and deductions governed by economic performance requirement in § 461(h))

Revenue Rulings and Notice

Rev. Rul. 55-675, 1955-2 CB 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)

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

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

Rev. Rul. 75-154, 1975-1 CB 186 (pension payments by former partners of terminated partnership deductible; *Flood* followed)

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

Rev. Rul. 77-56, 1977-1 CB 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. 80-235, 1980-2 CB 229 (nonrecourse note not included in asset basis because payable only out of cash flow, citing, *inter alia, Denver & Rio Grande Western RR Co., Columbus and Greenvillle Ry.* and *Albany Car Wheel Co.*)

Rev. Rul. 81-262, 1981-2 CB 164 (nonrecourse note transferred in satisfaction of franchise fee is a contingent obligation; even if noncontingent, no deduction because nonrecourse note is not cash or property under 153(d)(2)(b))

Notice 2001-44, 2001-2 CB 77 (solicits comments on methods of accounting for contingent nonperiodic payments made pursuant to notional principal contracts under Reg. § 1.446-3)

Chief Counsel Guidance

GCM 34418 (Feb. 3, 1971) (Background to Rev. Rul. 71-450; Chief Counsel reaffirms *James M. Pierce Corp.* and Rev. Rul. 68-112 in response to Department of Justice concerns)

PLR 7816063 (Jan. 23, 1978) (after purchase of Target stock and liquidation of Target under old § 334(b)(2), acquiring parent may deduct contributions to Target's qualified pension plan, including those attributable to unfunded plan liabilities)

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

PLR 8152056 (Sept. 29, 1981) (after purchase of Target stock, Acquiror established qualified pension plan to continue benefits under Target plan; Acquiror may deduct contributions to Target's qualified pension plan, including those attributable to unfunded plan liabilities)

PLR 8202115 (Oct. 16, 1981) (similar to PLR 8152055)

PLR 8205022 (Nov. 3, 1981) (after purchase of Target's assets, Acquiror adopted a new qualified pension plan to pay benefits under a frozen qualified pension plan, including Target's unfunded liability; Acquiror may deduct contributions to the new plan, including those attributable to unfunded plan liabilities)

PLR 8411106 (Dec. 16, 1983) (similar to GCM 39274)

TAM 8436002 (Mar. 23, 1984) (similar to GCM 39274)

PLR 8429014 (Apr. 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)

GCM 39274 (Aug. 16, 1984) (payments to meet pre-acquisition minimum funding requirements to continue qualified pension plan deductible to Acquiror as made, even if computed in part by reference to past service—*David R. Webb Co.* distinguished; but payment of liability to PBGC for termination of plan and liability for unpaid benefits capitalized)

PLR 8612050 (Dec. 23, 1985) (in stock sale with § 338(g) election, New T includes in income "imputed payment" by Old T to New T (reduction in purchase price) for New T to assume old T's liability for prepaid subscriptions and seminars (subject to deferral under § 455 and Rev. Proc. 71-21); Old T reports imputed payment as gain on deemed asset sale but deducts imputed payment; *James M. Pierce Corp.* followed in context of § 338(g))

AOD 1986-027 (acquiescence in Commercial Security Bank v. Commissioner, even though payment analysis considered "somewhat strained" and "dubious at best")

PLR 8749076 (Sept. 11, 1987) (similar to PLR 8612050)

TAM 8939002 (June 15, 1989) (deduction allowed to Seller for assumption of liability for accrued compensation; but, under § 404(a)(5), no deduction for assumption of liability for deferred compensation until income inclusion by employee; *Commercial Security Bank* distinguished because of § 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 (Dec. 24, 1990), modifying TAM 8741001 (June 16, 1987) (before stock sale with § 338(g) election, Target 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 (Apr. 23, 1991) (Target 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 (Oct. 16, 1992) Issues 2 and 3 (after stock sale with § 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 (§ 165(a) loss for warrants, § 162 deduction for employee stock options))

PLR 9313025 (Jan. 5, 1993) (taxpayer's basis in alternative energy plant is cost less agency funds provided via contingent loan; basis will be restored as payments are made to agency)

PLR 9317005 (Jan. 15, 1993) (similar to PLR 9313025)

FSA 1999-1068 (Oct. 8, 1993) (Acquiror's assumption and payment of retiree health and life insurance benefit capitalized; if no legal obligation to close the plant, plant closure expenses deductible)

TAM 9438001 (Apr. 21, 1994) (Target may deduct amounts paid by Acquiror to acquire Target's employee stock options, SARs, etc.; Acquiror's treatment not discussed)

FSA 1994 FSA LEXIS 490 (May 9, 1994) (similar to GCM 39274)

TAM 9540003 (June 30, 1995) (in connection with successful tender offer by Acquiror for Target stock, Target made payments to cancel its stock options and stock appreciation rights; amounts paid reflected "premium" in Target stock value from Acquiror's offer; Target may deduct all amounts paid, including "premium")

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

TAM 9731001 (Jan. 31, 1997) (similar to TAM 9721002)

TAM 9832002 (Feb. 5, 1998) (prepaid subscription to partnership, deferred under § 455, treated as "liability" that increases basis in partnership interests)

PLR 9842008 (Oct. 16, 1998) (payments by Seller of Target stock for later-discovered environmental contamination liabilities of Target related back to the sale; Seller entitled to capital loss)

TAM 199916043 (Jan. 11, 1999) (seller of funeral home business could not include in basis, or reduce amount realized on sale to reflect cash held in trust for pre-need customer or pre-need receivables, because seller had not included such cash or receivables in its taxable income; *see* Rev. Rul. 87-127 and § 685)

PLR 200004040 (Oct. 29, 1999) (on sale of nuclear power plant, Seller transferred plant assets, including decommissioning fund assets, and Acquiror assumed decommissioning liability; Seller includes in amount realized at closing present value of liability assumption, but simultaneous offsetting deduction allowed; Acquiror recognizes no gain on receipt of decommissioning funds (Rev. Rul. 71-450 distinguished); Acquiror may not allocate decommissioning liability specially as consideration paid for fund assets but must use § 1060 and allocate all consideration to all assets)[*]

FSA 200048006 (Aug. 14, 2000) (on sale of stock with a 338(h)(10) election, Seller indemnified Acquiror and "New T" for pre-acquisition taxes; Acquiror may only deduct post-acquisition interest on state tax liability; New T makes upward adjustment to basis of its assets when state tax liability and pre-acquisition interest become fixed and determinable and downward adjustment to basis when payments are made by Seller to the state tax authority)

FSA 200047015 (Aug. 16, 2000) (parent may not deduct cost of reimbursing its first subsidiary the cost of paying a legal judgment against parent's second, arguably bankrupt subsidiary, when cause of action arose against second subsidiary before parent purchased subsidiary, and despite oral agreement (confirmed by letter) between parent and first subsidiary that parent would pay judgment)

FSA 200110020 (Dec. 6, 2000) (Acquiror cashed out nonqualified stock options after acquiring stock of Target and causing target to be merged into Acquiror; payments deductible by Target, not Acquiror; issue whether merger caused Acquiror to step into Target's shoes and so become eligible for deduction referred to Associate Chief Counsel (Corporate))

PLR 200127022 (Apr. 4, 2001) (damages paid by physician who sold his practice and then violated terms of covenant not to compete deductible under § 162(a))

FSA 200148006 (July 30, 2001) (funding of employee bonus plan of target corporation by acquiring corporation as a condition to a § 338(h)(10) transaction is capital expenditure; distributions from plan for post-acquisition services may be currently deducted as compensation expense)

TAM 200427023 (March 5, 2004) (target whose stock was sold received indemnity payment from assignee of seller of target stock for breach of contractual obligations assumed by assignee; payment taxed as ordinary income; *Arrowsmith* not applied)

PLR 200510008 (Nov. 23, 2004) (rural electric cooperative purchased electricity with price subject to adjustment 75 days after year-end; *ruled*, adjustment meets all parts of the "all events" test under §§ 451 and 461, including requirement that amount be "determinable"; thus, income for year of power delivery takes adjustment into account)

PLR 200602028 (Sept. 28, 2005) (sale of nuclear power plant to city, which assumes decommissioning liability through nonqualified nuclear decommissioning Trust; Seller continues to collect rates from customers and remitting funds to Trust as city's agent; Seller allowed deduction at closing to offset amount realized attributable to city's assumption of decommissioning liability; Seller's collections as agent not taxable to Seller)

[*] This ruling is substantially similar to several others, *e.g.*, PLR 200302013 (Sept. 30, 2002); PLRs 200302009 through 200302012 (Sept. 27, 2002); PLR 200218019 (Jan. 30, 2002); PLR 200215037 (Jan. 14, 2002); PLR 200125066 (Mar. 26, 2001); PLR 200125007 (Feb. 20, 2001); PLR 200121028 (Feb. 20, 2001); PLR 200042006 (July 11, 2000); PLR 200037020 (June 9, 2000); PLRs 200034007-08 (Aug 28, 2000); PLR 200034009 (May 18, 2000); PLR 199943041 (July 21, 1999); PLR 199952074 (Sept. 28, 1999). Several of these rulings are discussed in J. Cummings, "Capitalization—Selling Nuclear Decommissioning Funds," 195 DTR J-1 (Oct. 12, 2010).

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; payment deductible to buyer, not capitalized as adjustments to purchase price, because obligation contingent on gas purchases and market price, and because contracts not taken into account in determining purchase price)

PLR 201214007 (Jan. 3, 2012) (Acquiror bought wind energy facilities subject to right and obligation to sell facility power output to a purchaser under power purchase agreement (PPA); IRS ruled that Acquiror's cost paid for facility included price attributable to PPA, so that Acquiror may use this price in computing accelerated depreciation; observers believe this price is eligible for § 1603 grant or § 48 credit; does PLR suggest that PPA obligations assumed by Acquiror would be treated as reduction in FMV of facility, not as additional purchase price?)

Commentary

W. Landis, "Liabilities and Purchase Price," 27 Tax Lawyer 67 (1973)

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

D. Schenk, "*Arrowsmith* and its Progeny: Tax Characterization by Reference to Past Events," 33 Rutgers L. Rev. 317 (1980)

J. Sterling, Letter to D. K. Dolan, dated Oct. 27, 1987, Tax Notes Doc. No. 87-7074

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

M. Schler, "Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More," 43 Tax L. Rev. 605 (1988)

J. Lynch, "Transferring Assets Subject to Contingent Liabilities in Business Restructuring Transactions," 67 TAXES 1061 (1989)

N.Y.S. Bar Ass'n Tax Section Committee on Tax Accounting Matters, "Report of Proposed Regulations Relating to Economic Performance Requirements," 90 TNT 242-21 (Nov. 7, 1990).

N.Y.S. Bar Ass'n Tax Section Committee on Alternative Minimum Tax, "Report on the Federal Income Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions," 49 Tax Notes 883 (Nov. 19, 1990)

L. Sheppard, "Corporate Tax Lawyers Tackle Intractable Issues," 47 Tax Notes 777 (May 14, 1990)

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)

G. Soukup, "Accounting for Assumed Liabilities Not Yet Accrued by the Seller: A Response," 48 Tax Notes 637 (July 30, 1990)

A. Youngwood, "The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions," 44 Tax Lawyer 765 (1991)

T. Yancey, "Emerging Doctrines in the Tax Treatment of Environmental Cleanup Costs," 70 TAXES 948 (1992)

R. Wootton, "Mrs. Logan's Ghost: The Open Transaction Doctrine Today," 71 TAXES 725 (1993)

A. Shrago, "The Uncertain Tax Treatment of Liabilities in Corporate Acquisitions," 52 N.Y.U. Inst. Fed. Tax'n § 19 (1994)

R. Reinhold, "Contingent Liabilities and Contingent Purchase Price in Taxable Asset Acquisitions and Section 338(h)(10) Transactions," 53 N.Y.U. Inst. Fed. Tax'n § 13 (1995)

E. MacNeil, G. Carrington & R. Friedman, "Dealing with Contingent Liabilities in Taxable Asset Acquisitions," 83 J. Taxation 208 (Oct. 1995)
D. Halperin, "Assumption of Contingent Liabilities on Sale of a Business," 2 Fla. Tax Rev. 673 (1996)
M. Silverman, S. Serling & J. Epstein, "IRS Remediates Environmental-Cost Deduction Mess," 48 Tax Executive 33 (1996)
P. Canellos, "Reasonable Expectations and the Taxation of Contingencies," 50 Tax Lawyer 299 (1997)
L. Sheppard, "Cognitive Dissonance on Contingent Liabilities in Asset Acquisitions," 78 Tax Notes 142 (Jan. 12, 1998)
J. Adams, "Constructing Transactions to Deal with Contingent Liabilities," The Tax Club (Jan. 1998)
V. Penico, M. Silverman & M. Yecies, "Section 338 and Contingent Liabilities in Taxable Acquisitions," 3 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 1999, 595
M. Kovey, "Insurers Want Purchase Allocation Regs Clarified," 2000 TNT 145-16 (July 27, 2000)
B. Cornell et al. ed., Letter Rulings, "Acquiring Corporation May Not Deduct Target's Contingent Liabilities," 94 J. Taxation 121 (Feb. 2001)
J. Starkey, "Tax Treatment of Employee Stock Options in Mergers and Acquisitions," 90 Tax Notes 1231 (Feb. 26, 2001)
B. Raby and W. Raby, "Contingent Liability Payments in Business Purchases," 92 Tax Notes 941 (Aug. 13, 2001)
P. Cook and M. Sperry, "Contingent Liabilities after Illinois Tool Works, Inc.," 2 Mergers & Acquisitions 12 (Nov. 2001)
J. Henderson, Ltr to J. Paravano, 2003 TNT 11-20 (Jan. 9, 2003)
G. Pavin & G. Towne, "Basis Distortions on Nuclear Power Plant Purchases," 106 Tax Notes 565 (Jan. 31, 2005)
M. Yecies, "Contingent Liabilities in Taxable Asset Acquisitions," 4 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 45
K. Keyes, "The Treatment of Contingent Liabilities in Taxable Acquisitions," 5 PLI Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 46
R. Scarborough, "Property Purchase or Payment in Kind? The Oxford Paper Conundrum," 62 Tax Lawyer 823 (2009)
J. Cummings, "Capitalization—Selling Nuclear Decommissioning Funds," 195 DTR J-1 (Oct. 12, 2010)
N.Y.S. Bar Ass'n Tax Section Rpt. No.1278, "Report on Insolvency under Section 108: The Treatment of Contingent Liabilities" (Nov. 20, 2012)
N.Y.S. Bar Ass'n Tax Section Rpt. No.1281, "Report on Tax Treatment of 'Deferred Revenue' Assumptions by the Buyer in Taxable Asset Acquisitions" (Jan. 7, 2013)
R. Feldgarden, "Assuming the Liability to Provide Property or Services in a Purchase," 138 Tax Notes 1153 (June 2013)

W. Seago & E. Schnee, "Section 338 Transactions: why ADSP and AGUB Can Differ," 119 J. Taxation 157 (Oct. 2013)

G. Cohen, "Deferred Revenues in Partnership and Corporate Acquisitions," 143 Tax Notes 201 (Apr. 2014)

J. Cummings, "Paying for Assumption," 143 Tax Notes 487 (Apr. 2014)

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 § 382 limitation)

Regulations

Reg. § 1.1502-11(b) (on sale of stock of consolidated return subsidiary Target, Target's loss in year of sale does not offset gain from sale of Target stock; limitation intended to prevent a cycle of reductions in the basis of the Target stock that absorbs the Target loss with no tax benefit)

Reg. § 1.1502-76(b) (on sale of stock of consolidated return subsidiary Target, rules to determine whether selling consolidated group takes into account Target deductions generated in year of sale, or whether Target takes these deductions into account during its next taxable year)

Reg. § 1.1502-36(d)(4)(ii)(C) (if stock of consolidated subsidiary (T) is sold at a loss, T's favorable tax attributes (NOLs, asset basis, etc.) may be reduced to prevent loss duplication; if contingent liabilities become payable by T after closing, T may lose deduction if loss on stock sale exceeds attributed available for reduction)

Court Decisions

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

Deputy v. Dupont, 308 U.S. 488 (1940) (expense incurred by shareholder to borrow corporation stock to be provided to members of corporation's executive committee not deductible, because incurred for benefit of corporation)

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 Target stock indemnified Acquiror against Target'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) (on sale of Target stock, Target shareholders paid pre-closing tax and interest thereon under indemnity agreement; *held*, payments made by shareholders became property of Target, and interest deductible to Target, not reduction to purchase price of Target stock)

Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964) (expenditures by parent corporation to corporate subsidiary's employees not deductible by parent)

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 Acquiror 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 Acquiror because Target's 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 Acquiror was taxed on income in Canada not dispositive)

Clay v. Commissioner, T.C. Memo 1981-375 (1981) (Sellers of stock of vending machine company indemnified Acquiror against undisclosed liabilities; indemnity payment *held* offset against sale proceeds and capital loss to Seller under *Arrowsmith*, not ordinary deduction; litigation expenses for arbitration to determine indemnity damages also capital expenditures)

Inland Asphalt Co. v. Commissioner, 756 F.2d 1425 (9th Cir. 1985) (indemnity payment by Target (an S corporation) to Seller of Target stock for tax deficiencies on previous transaction treated as dividend, not sale price adjustment, because payments related back to the prior transaction, not the sale of Target stock)

Revenue Rulings and Notice

Rev. Rul. 58-374, 1958-2 CB 396, clarified by Rev. Rul. 83-73, 1983-1 CB 84 (by agreement, Seller of Target stock indemnified Target for pre-sale Federal income tax and all interest thereon through payment, and Target paid over to Seller Federal excess profits tax refunds it received, including interest thereon (less income tax paid on the interest by Target); tax payment and refund and interest paid and received thereon are all adjustments to the purchase price of the Target stock under *Arrowsmith*)

Rev. Rul. 2003-98, 2003-2 CB 378 (Target grants nonqualified stock options to employee; later, Acquiror buys Target stock and grants Acquiror stock options to employee, who surrenders his Target options; employee recognizes compensation income when Acquiror option is exercised or cashed-out; Target, not Acquiror, gets offsetting deduction)

Notice 2003-65, 2003-2 CB 747 (IRS requests comments on how built-in loss items should be treated under § 382(h))

Chief Counsel Guidance

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

PLR 8429014 (Apr. 16, 1984) (Seller of Target stock made payments to Target's medical claims administrator after stock sale; payments *ruled* capital contributions, not income to Target, and deductible to Target; payments by Acquiror of Target stock to Seller for tax benefit of medical payments *ruled* adjustments to purchase price for Target stock; *see* CCA 200901033 (Sept. 5, 2008), below)

PLR 9029058 (Apr. 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) (corporation entitled to current deduction for environmental cleanup costs even though costs are subject to indemnification under stock purchase agreement; VCA followed)

FSA 200048002 (May 22, 2000) (Seller deferred tax on advance payments for services under Rev. Proc. 71-21 (*superseded by* Rev. Proc 2004-34) and then sold its business to Buyer; *ruled*, deferral terminates, both because Seller's liability to perform services terminated (citing *James M. Pierce*), and because Buyer assumed this liability (citing Reg. § 1.1001-2(a)(1))

FSA 200147013 (July 10, 2001) (on sale of Target stock, Seller assumed liability for claims against Target; Seller's subsidiary incurred expenses to administer these claims; expenses not deductible to Seller's subsidiary because they are Target's expenses, and under *Arrowsmith*, they relate back to the sale of Target stock; thus, capital loss to Seller; *VCA* followed)

LAFA 20055202F Sept. 13, 2005) (In sale of stock, Target purports to distribute to Seller the right to specified percentage of anti-dumping subsidy payments received by Target after closing; Acquiror remits such amounts to Seller; dividend declaration treated as executory promise to pay dividend in the future and disregarded, because contingent on anti-dumping award; subsidy payments taxable to Target as received and additional; payment to Seller treated as additional purchase price)

PLR 200518014 (Dec. 30, 2004), *revoked retroactively*, PLR 200613022 (Mar. 31, 2005) (consolidated parent C sells stock of subs X and Y to consolidated parent B; parties agreed that any X or Y NOL in post-closing years would not be carried back to pre-closing years; after law was changed to increase carryback period from 2 years to 5 years, under new agreement C claimed refund for carryback of X and Y NOLs to pre-closing years and paid $^2/_3$ of refund to B; in original ruling, *ruled*, payment by C to B not adjustment to purchase price for X and Y stock under *Arrowsmith*, because made under new agreement; payment ordinary income to B and deductible to C; rulings on income to B and deduction to C revoked because "not in accord with the views of the Service"; *see* J. Prusiecki, "Brilliant Advocacy or Very Good Luck?" 107 Tax Notes 1751 (June 27, 2005))

CCA 200901033 (Sept. 5, 2008) (supplemental to PLR 8429014 (Apr. 16, 1984), above; Target and Acquiror merged into X Corp.; payments by Seller to claims administrator after merger *ruled* capital contributions by Seller to X, with same effect as pre-merger payments; tax benefit payments by X to Seller *ruled* to have no tax effect to X, because the Target stock basis had disappeared in the merger, but still to offset Seller's capital losses from the payments to claims administrator)

CCA 201310039 (Dec. 18, 2012) (same facts as PLR 200518014; *ruled*, portion of refund retained by C is gross income to C; no ruling on treatment to B or to X and Y)

Commentary

W. Potter, "Approaching Deferred Revenue in Corporate Stock Acquisitions," 144 Tax Notes 1071 (Sept. 2014)

TAX-FREE TRANSACTIONS

TAX-FREE TRANSACTIONS – CONTINGENT AND ESCROWED STOCK AND OPTIONS TO ACQUIRE STOCK

Code Provisions

Section 163(l) (no deduction for interest on debt instruments payable in issuer stock)

Section 356(a)(1) (gain, but not loss, is recognized to the extent of the lesser of the FMV of the warrants or the cash received)

Section 483(f) (regulation authority on imputed interest for contingent payments)

Regulations and Treasury Decisions

Reg. § 1.354-1(d) Example 4 (Section 354 does not apply to an exchange of common stock for options to acquire stock of the same company)

Reg. § 1.356-1(a) (gain, but not loss, is recognized to the extent of the lesser of the FMV of the warrants or the cash received)

Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b) (options to acquire stock treated as "zero-principal" securities)

Reg. § 1.356-3(c) Examples 7, 8, and 9 (illustrating treatment of right to acquire stock as security having no principal amount)

Reg. § 1.356-6 (nonqualified preferred stock exchanged for anything other than NQPS or a right to acquire NQPS is not stock or securities under Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b))

Reg. §§ 1.368-1(e)(2) (TD 9565, Dec. 16, 2011) (contingent or escrowed consideration received by target shareholders in purported reorganization does not prevent FMV of stock from being fixed, for continuity-of-interest purposes, at the time a binding contract is entered into, if described conditions are met)

Reg. §§ 1.368-1(e)(2)(v) Example 2 (TD 9565, Dec. 16, 2011) (escrowed stock forfeited to Acquiror after purported reorganization; FMV of stock still may be fixed, for continuity-of-interest purposes, at the time a binding contract is entered into, but forfeited stock does not count toward continuity)

Prop. Reg. §§ 1.368-1(e)(2)(vi) and (vii) (for continuity-of interest purposes, use of average traded prices of Acquiror stock during periods after signing of binding contract and before Closing and use of floor and ceiling prices and collars allowed)

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")

61 Fed. Reg. 67508 (Dec. 23, 1996) (treatment of options to acquire stock as zero-principal-amount securities)

TD 8752 (Jan. 6, 1998) (final Regulations regarding treatment of options to acquire stock as zero-principal-amount securities)

TD 8882 (May 16, 2000) (final Regulations regarding treatment of exchange of NQPS for purposes of §§ 354, 355, and 356)

TD 9565 (Dec. 16, 2011) (final Regulations regarding signing date rule to determine Acquiror stock FMV for continuity-of-interest purposes)

Prop. Reg. §§ 1.368-1(e)(2)(vi), (vii) (Dec. 16, 2011) (proposed "average price" rule and "floor" and "ceiling" rules to determine Acquiror stock FMV for continuity-of-interest purposes)

Court Decisions

Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942) (stock options are not stock)

Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960) (right to receive contingent stock treated as "stock" eligible for tax-free treatment in reorganization)

Hamrick v. Commissioner, 43 T.C. 21 (1964), *acq. in result only*, 1966-2 CB 5 (right to receive contingent stock treated as "stock" eligible for tax-free treatment in reorganization)

Fox v. United States, 510 F.2d 1330 (1974) (imputed interest required in contingent stock deal)

Solomon v. Commissioner, 67 T.C. 379 (1976) (*similar to Fox*)
Jeffers v. United States, 556 F.2d 986 (Ct. Cl. 1977) (*similar to Fox*)
Catterall v. Commissioner, 68 T.C. 413 (1977) (*similar to Fox*)
Cocker v. Commissioner, 68 T.C. 544 (1977) (*similar to Fox*)
Katkin v. Commissioner, 570 F.2d 139 (6th Cir. 1978) (*similar to Fox*)
Vorbleski v. Commissioner, 589 F.2d 123 (3d Cir. 1978) (*similar to Fox*)
Feifer v. United States, 500 F. Supp. 102 (N.D. Ga. 1980) (*similar to Fox*)
Kingsley v. Commissioner, 662 F.2d 539 (9th Cir. 1981) (*similar to Fox*)
Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1987) (*similar to Fox*)

Revenue Rulings and Revenue Procedure

Rev. Rul. 57-586, CB 1957-2, 249 (certificates of contingent interests in stock of Acquiror received by Target shareholders in merger of Target into Acquiror treated as boot, not stock, because transferable; *Carlberg* not followed)

Rev. Rul. 66-112, 1966-1 CB 68 (contingent right to receive additional Acquiror voting stock based on Target'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 § 483)

Rev. Rul. 67-90, 1967-1 CB 79 (same as Rev. Rul. 66-112, where number of additional shares contingent on future FMV of Acquiror stock)

Rev. Rul. 70-120, 1970-1 CB 124 (no imputed interest on escrowed stock in reorganization, if Target shareholders vote and receive dividends)

Rev. Rul. 70-300, 1970-1 CB 125, clarified, Rev. Rul. 72-35, 1972-1 CB 139 (imputed interest on contingent stock issued in reorganization)

Rev. Rul. 72-32, 1972-1 CB 48 (interest accrues on contingent stock based on earn-out in reorganization; interest deductible when obligation to issue contingent stock becomes fixed)

Rev. Rul. 73-298, 1973-2 CB 173 (in reorganization like that of Rev. Rul. 67-90, where Target shareholders receive contingent stock; § 483 interest imputation applies)

Rev. Rul. 75-456 , 1975-2 CB 128 (contingent stock issued in reorganization remains tax-free when exchanged for stock of second acquiror in second reorganization – *see also* PLR 9838007 (June 16, 1998))

Rev. Rul. 76-42, 1976-1 CB 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 CB 108 (escrowed stock in C reorganization returned in settlement of dispute for cash equal to half of stock FMV; cash payment viewed as separate redemption of stock in FMV 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. Rul. 78-376, 1978-2 CB 149 (return of escrowed stock issued in C reorganization, based on FMV of stock at time of return, treated as taxable sale of escrowed stock)

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

Rev. Rul. 2007-49, 2007-2 CB 237 (subjecting vested shares owned by employee to new restrictions, making them nonvested, has no effect under that provision; exchange of vested shares for nonvested shares in tax-free reorganization treated as transfer under § 83, but tax-free and eligible for § 83(b) election; if exchange is a taxable exchange, gain or loss is recognized on transfer of vested shares, but receipt of nonvested stock is still eligible for § 83(b) election)

Chief Counsel Guidance

PLR 9827027 (Apr. 3, 1998) (example of private ruling on contingent and escrowed stock)

PLR 200052027 (Sept. 29, 2000) (§ 163(l) does not disallow deductions for interest paid or accrued on notes issued at the same time issuer purchases put options on its convertible preferred stock)

Commentary

D. Tillinghast, "Contingent Stock Pay-Outs in Tax-Free Reorganizations," 22 Tax Lawyer 467 (1969)

J. P. Holden, "Unraveling the Mysteries of Section 305," 36th Ann. N.Y.U. Inst. Fed. Tax'n 781 (1978)

R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981)

J. Fleming, "Rethinking Contingent Price Reorganizations," 9 J. Corp. Tax'n 3 (1982)

FAS No. 128 (1997) (treatment of escrowed and contingent stock in computing earnings per share for financial accounting purposes)

M. Jackel & J. Blanchard, "Reflections on Liabilities: Extension of New Law to Partnership Formations," 91 Tax Notes 1579 (2001)

R. Willens, "Contingent Stock Acquisitions Should Gain Popularity in Uncertain Times," Daily Tax Report June 23, 2003

J. L. Cummings & R. P. Hanson, "New Limitations on Corporate Built-in Losses," 107 Tax Notes 1553 (2005)

K. Keyes, "Dealing With Contingent Stock and Contingent Liabilities in Tax-Free Transactions," 13 PLI Corporate Tax Practice Series, Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2013, 178

American Bar Ass'n Section of Taxation, "Comments on Temporary and Proposed Regulations Regarding the Measurement of Continuity of Interest Under Section 368" (Feb. 26, 2010)

New York State Bar Ass'n Tax Section, "Report on the Proposed Continuity of Interest Regulations (May 18, 2012)

American Bar Ass'n Section of Taxation, "Comments Concerning Measurement of Continuity of Interest" (June 26, 2012)

TAX-FREE TRANSACTIONS – CONTINGENT LIABILITIES

Code Provisions

Section 357(c)(3) (liability excluded from § 357(c) computation if payment would give rise to a deduction)

Section 357(d) (separate rules for recourse and nonrecourse liabilities to determine whether a liability is treated as "assumed" so as to result in basis step-up and possible gain recognition in otherwise tax-free asset transfer (enacted by Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(1) (106th Cong., 1st Sess. 1999))

Section 358(d) (where shareholder transfers property to corporation (§ 351 or 361), and corporation assumes liability giving rise to deduction (§ 358(d), stock basis reduced by this liability to extent stock basis exceeds FMV – exception for full business transfers, as in Rev. Rul. 95-74; note: Treasury directed to adopt similar rule for partnership transfers (Pub. L. No. 106-554, § 309(c)))

Section 358(h) (loss disallowance rule (enacted in the Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, § 309(a) (106th Cong. 2d Sess. 2000)) that reduces the basis of the stock to the extent that (1) it exceeds the stock's FMV, and (2) a liability (including a contingent liability) is assumed by the transferee corporation in exchange for the stock)

Section 362(d) (limitation on asset basis step-up attributable to assumed liabilities: no basis increase above FMV; liability assumption disregarded for asset basis purposes if no tax paid on recognized gain)

Section 362(e)(1) (2004 Jobs Act amendment to limit importation of net built-in losses in § 351 exchanges and reorganizations, including contingent liabilities)

Section 362(e)(2) (2004 Jobs Act amendment to limit duplication of net built-in losses in § 351 exchanges)

Section 381(c)(16) (in acquisitive reorganization, Parent succeeds to deduction of Target's deductible liabilities, except those which reduce consideration paid in reorganization; *see also* § 381(c)(4))

Section 7701(o) (where the economic substance doctrine applies, taxpayer must show both non-tax change in economic position and business purpose)

Legislative Proposal

Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong., 1st Sess. (1999), Section 1512 (would have broadened anti-abuse rule of § 357(b) by changing "the principal purpose" to "a principal purpose" and eliminating "on the exchange" – vetoed September 23, 1999)

Regulations, Treasury Decisions and Proposed Regulations

Reg. § 1.301-1(g) (applying § 357(d) definition of an assumption to distributions under § 301)

Reg. § 1.358-5 (§ 358(h), which reduces basis of stock of transferee corporation in § 351 exchange and reorganization for contingent liabilities, to extent of net loss, applied without regard to exception for transfers substantially all of the assets associated with the liability)

Reg. § 1.362-4(h) Example (5) (no § 362(e)(2) reduction in basis of property transferred under § 351, or in basis of transferee stock, attributable to assumed liabilities)

Reg. §§ 1.362-4(g)(12) and 1.362-4(h) Example (8)(ii) (no § 362(e)(2) reduction in basis of partnership interest transferred under § 351, or in basis of transferee stock, attributable to partnership liabilities)

Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a), (c) (deductibility of payments of Target obligations by Parent after reorganization)

Reg. § 1.1502-76(b)(4) Example (5) (if Target 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)

TD 8924 (Dec. 20, 2000) (in adopting Temp. Reg. § 1.301-1T(g), Treasury and IRS announce that regulations will be adopted on payments of assumed liabilities; interim view is that payment by non-assuming person treated as, *e.g.*, dividend or capital contribution)

TD 9062 (June 24, 2003), Reg. § 1.752-6T (applying principles of § 358(h) to liabilities assumed by partnerships – effective for transactions from October 18, 1999 until June 24, 2003)

TD 9207 (May 26, 2005). Reg. §§ 1.358-7, 1.752-0, 1.752-1, 1.752-6 and 1.752-7 (system to account for partnership "obligations" – other than "liabilities" taken into account in income, gain or asset basis; actual or deemed assumption by partnership of such obligations does not result in immediate reduction of partner's basis in partnership interest; instead, (1) any deduction or capital item resulting from obligation becoming a "liability" (*e.g.*, payment of a deductible item) is allocated among partners using § 704(c) principles, and (2) if obligation is separated from partner to whom allocated (*e.g.*, partner disposes of partnership interest), basis in partnership interest is reduced at that time, and later deduction is available only to that partner)

Notice of Proposed Rulemaking, REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11903 (Mar. 10, 2005) (Transfer cannot qualify as reorganization, § 351 exchange or § 332 liquidation unless net value – FMV of assets over amount of liabilities – is transferred; "liabilities" include all obligations, whether or not taken into account for other tax purposes, but method of determining amount of liabilities not specified)

Proposed Reg. §§ 1.362-4(e)(3) and (4) (in § 351 transfer of net loss assets, if stock basis reduction is elected instead of asset basis reduction, stock basis is reduced by amount of net built-in-loss in gross assets; contingent liabilities not taken into account for this purpose)

Advance Notice of Proposed Rulemaking

Advance Notice of Proposed Rulemaking, REG 100818.01, RIN 1545-A474, "Liabilities Assumed in Certain Transactions" (also Announcement 2003-37, 2003-1 CB 1025), 68 Fed. Reg. 23,931 (May 6, 2003) (request for comments regarding assumption of numerous liabilities in § 351 exchange)

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* part of cost of acquired assets, not deductible)

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* either voluntary payment or consideration for partnership assets, not deductible)

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* part of consideration for predecessor's assets, not deductible)

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 found liable for predecessor corporation's stock transfer tax, because successor had assumed predecessor's liability; payment of tax *held* part of cost for predecessor's assets, not deductible)

Rodney, Inc. v. Commissioner, 145 F.2d 692 (2d Cir. 1944) (liability for accrued interest assumed by shareholder in liquidation of corporation and later paid by shareholder capitalized and not deductible)

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* part of consideration paid for partnership business, not deductible)

W.D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948) (tax liability assumed in tax-free merger, *held* 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 *held* deductible by successor)

Portland Gasoline Company v. Commissioner, 181 F.2d 538 (5th Cir. 1950) (payment by Acquiror of Seller corporation's assets of liability on guarantee by Seller of note issued by Seller's affiliate *held* capitalized in cost of reorganization, not deductible)

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

Kaufmann v. Commissioner, 10 TCM (CCH) 790, PH TCM ¶ 51250 (1951) (shareholders of Target, acquired in merger, paid Target'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 § 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)

Central Electric & Gas Co. v. United States, 159 F. Supp. 353 (Ct. Cl. 1958) (in purchase of corporate stock, Seller agreed to indemnify Acquiror for pre-closing tax and interest in excess of amount reserved; pre-closing tax and interest assessed against Target but paid by Seller; *held*, interest deductible to Target)

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, because 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 Target properties 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 part of cost of Acquiror stock, was not deductible)

Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (individual bought stock of corporations for cash and notes and later transferred stock of one corporation to another; transferee "assumed" liability for the notes, but individual remained secondarily liable; *held*, no "assumption" because individual still might have to repay; thus no dividend)

Enoch v. Commissioner, 57 T.C. 781 (1972), *acq. in part*, 1974-2 CB 2, 4, *nonacq.*, 1974-2 CB 5 (where a liability is treated as assumed by the transferee, a later payment by the party whose liability was treated as assumed should be treated in accordance with the relationship of the parties)

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)

Helmer v. Commissioner, T.C. Memo. 1975-160 (option written by partnership not a liability under § 752, because it could expire unexercised)

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 Target's tax-free merger into Acquiror, Target terminated employment contract with G; Target shareholders agreed to indemnify Acquiror for part of costs of G's termination; G sued Acquiror for damages; Acquiror paid to settle suit and was partly indemnified; IRS conceded deductibility of payment not indemnified, under § 381(c)(16); indemnified payment *held* deductible under literal language of regulations under §§ 381(c)(4) and 381(c)(16); also, deduction gives parties no advantage over deduction by Target; *see* published articles cited in opinion)

Long v. Commissioner, 71 T.C. 1 (1978), *aff'd in part and rev'd on other grounds*, 660 F.2d 416 (10th Cir. 1981) (contingent liabilities such as those arising out of lawsuits not § 752 liabilities until fixed or liquidated)

Salina Partnership LP, FPL Group, Inc. v. Commissioner, T.C. Memo. 2000-352 (short sale obligation had economic substance and was a § 752 liability; court emphasized need to achieve "parity between a partnership's aggregate inside basis in its assets and its partners' outside bases in their partnership interests" and distinguished *Helmer*, noting that there option could lapse unexercised but in short seller had obligation to close short sale)

Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), *aff'g in part, rev'g and remanding in part* 340 F. Supp. 621 (D. Md. 2004) (contingent liability shelter – loss on sale of stock received in § 351 exchange including assumption of OPEB liabilities – summary judgment for taxpayer reversed)

Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 200*6), rev'g* 94 AFTR 2d 2004-6708 (Ct. Fed. Cl. 2004), *cert. denied 167 L.Ed.2d 76* (2007) (contingent liability shelter—in § 351 exchange involving assumption of contingent liability, contingent liability treated as "liability" for purposes of §§ 357 and 358, and basis of stock of transferee corporation not reduced, because liability would result in deduction; loss on sale of stock of transferee corporation disallowed for lack of economic substance in transaction in which liabilities were assumed)

Klamath Strategic Investment Fund, L.L.C. v. United States, 98 AFTR 2d 2006-5495 (E.D. Tex. 2006), 472 F. Supp. 885 (E.D. Tex. 2007), *reconsideration denied*, 99 AFTR 2d 2007-2001 (2007), *aff'd*, 103 AFTR 2d 2009-2220 (5th Cir. 2009) (in offsetting option "Son-of-BOSS" borrowing and partnership investment transaction, purportedly as part of foreign currency investment strategy, district court held that Reg. § 1.752-6 could not be applied retroactively against taxpayer, because taxpayer was justified in relying on prior law, but disallowed claimed tax benefits, because the transactions lacked economic substance (although allowing deductions for related interest and expenses); court of appeals affirmed on the economic substance ground, declined to take up retroactivity issue and reversed district court decision to allow interest and expense deductions)

Jade Trading LLC, et al. v. United States, 80 Fed. Cl. 11, 100 AFTR 2d 2007-7123 (Ct. Fed. Cl. 2007) *aff'd* 598 F.3d 1372 (Fed. Cir. 2012) (offsetting foreign currency transactions lacked economic substance; *Coltec* applied to reach conclusion that obligation did not constitute § 752 liability)

Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008) (tax benefits of offsetting option Son-of-BOSS transaction disallowed; Reg. § 1.752-6 applied retroactively against taxpayer)

Kornman & Associates, Inc. v. United States, 101 AFTR 2d 2008-785 (5th Cir. 2008), *aff'g Colm Producer, Inc. v. United States*, 460 F. Supp. 713 (N.D. Tex. 2006) (tax benefits of short sale Son-of BOSS transaction disallowed, because short sale obligation treated as a § 752 liability under revenue rulings in effect before Reg. § 1.752-6)

Sala v. United States, 613 F.2d 1239 (10th Cir. 2010), *rev'g* 101 AFTR 2d 2008-1843 (D. Colo. Apr. 22, 2008) (district court allowed tax benefits of offsetting option Son-of BOSS transaction as having economic substance, distinguishing *Klamath*, and held that Reg. § 1.752-6 could not be applied retroactively against taxpayer, rejecting *Cemco*; court of appeals reversed on economic substance grounds, but, as in *Klamath*, did not address Reg. § 1.752-6.

Stobie Creek Investments LLC v. United States, 82 Fed. Cl. 636, 102 AFTR 2d 2008-5442 (Ct. Fed. Cl. 2008), *aff'd* 608 F.3d 1366 (Fed. Cir. 2010) (in trial court, obligation from offsetting foreign currency transaction did not constitute a § 752 liability because it lacked economic substance; step transaction doctrine used to collapse steps, retroactive application of Treas. Reg. § 1.752-6T invalid (this issue not appealed))

Marriott Int'l Resorts v. United States, 83 Fed. Cl. 291, 102 AFTR 2d 2008-6039 (Ct. Fed. Cl. 2008) (short sale, predated Notice 2000-44, effective date of Treas. Reg. § 1.752-6T, and Rev. Rul. 95-26, which held that short sales were § 752 liabilities; but, emphasizing need for symmetry in treatment of basis, court relied on Rev. Rul. 88-77 and Salina, to hold that short sale obligation constituted § 752 liability)

7050 Ltd. v. Commissioner, T.C. Memo 2008-112 (tax benefits of offsetting option Son-of BOSS transaction disallowed for two reasons: currency options were transferred to partnership after they had expired, and distribution of options by partnership to partner did not fully liquidate partner's interest)

Maguire Partners-Master Invs., LLC v. United States, 104 AFTR 2d 2009-7839 (C.D. Cal. 2009) (offsetting foreign currency options lacked economic substance, were economic shams and were recast under step transaction and substance-over-form doctrines; court also held that option obligation was a § 752 liability, relying on Rev. Rul. 88-77 and noting that short and long option positions were contractually linked; court also applied Cemco holding that Treas. Reg. § 1.752-6T was validly applied retroactively)

New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. 161 (2009) (offsetting foreign currency option transactions lacked economic substance even though there was small chance of big payout; court did not address whether § 752 liability existed or retroactive applicability of Treas. Reg. § 1.752-6T)

Clearmeadow Investments, LLC v. United States, 103 AFTR 2d 2009-2786 (Ct. Fed. Cl. 2009) (offsetting foreign currency options – taxpayer initially accepted IRS settlement initiative offer but breached agreement; court focused on Reg. § 1.752-6; taxpayer claimed it transferred a trade or business, an exception to § 1.752-6, an argument court rejected; *held*, transaction lacked economic substance)

Murfam Farms, LLC v. United States, 104 AFTR 2d 2009-5700 (Ct. Fed. Cl. 2009) (retroactive application of Reg. § 1.752-6 invalid; Government motion for summary judgment denied); 106 AFTR 2d 2010-5960 (Ct. Fed. Cl. 2010) (Government's motion to vacate earlier decision as moot, due to settlement, denied)

Bemont Investments, LLC v. United States, 106 AFTR 2d 2010-5542 (E.D. Tex. 2010) (transaction lacked economic substance)

Candyce Martin 1999 Irrevocable Trust v. United States, 108 AFTR 2d 2011-6693 (N.D. Cal. 2011) (transaction lacked economic substance)

Thrifty Oil Co. v. Commissioner, 139 T.C. 198 (2012) (contingent liability tax shelter in which taxpayer sold stock of transferee of liability at a capital loss, then deducted payment of underlying liability; *held*, deduction disallowed as double deduction of one economic loss)

Crispin v. Commissioner, 111 AFTR 2d ¶ 2013-829 (3d Cir. 2012) (currency swap tax shelter (CARDS) held to lack business purpose and economic substance; *see especially* footnote 3, describing Government brief as arguing that liability assumption creates asset basis only if taxpayer "will eventually pay those liabilities"—*see* Notice 2002-21)

Revenue Rulings, Notices and Revenue Procedure

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

Rev. Rul. 80-198, 1980-2 CB 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. 83-73, 1983-1 CB 84, *clarifying* Rev. Rul. 58-374, 1958-2 CB 396 (after tax-free merger, Target shareholders reimbursed Parent for pre-merger contingent liability; Parent deducts payment of the liability and reports no income for reimbursement; Target shareholders reduce their basis in Parent stock by reimbursement amount)

Rev. Rul. 83-155, 1983-2 CB 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 CB 36 (contingent environmental liabilities of transferor assumed in § 351 transfer of business not "liabilities" for § 357(c) purposes; amounts deductible by transferee as incurred; *Holdcroft* not followed)

Notice 99-59, 1999-2 CB 761 (BOSS tax shelter: corporation distributes property to shareholders, who assume liability that corporation is expected pay; result is loss on corporation's stock; loss created is artificial and disallowed due to lack of economic substance)

Notice 2000-44, 2000-2 CB 255 (Son-of BOSS tax shelter: taxpayer transfers property to a partnership with obligations said not to be treated as "liabilities for § 752 purposes – *e.g.*, premium borrowing or written options on securities – to create a built-in loss in the partnership interest that then would be sold)

Notice 2001-17, 2001-1 CB 730 (stating IRS intention to challenge contingent liability tax shelters on various specified grounds)

Rev. Rul. 2002-1, 2002-1 CB 268 (D grants restricted D stock and nonqualified options on D stock to employees; upon spin-off of C by D, the employees' rights are cancelled, and restricted stock and nonqualified options on both D and C stock are substituted; when restrictions on stock lapse and options are exercised, no gain or loss is recognized to D or C, and D and C each is entitled to deductions with respect to its own stock)

Notice 2002-21, 2002-1 CB 730 (IRS will disallow loss from property basis attributable to assumption of joint and several liability for debt secured by property that taxpayer does not own—*see, e.g.*, *Crispin v. Commissioner*)

Rev. Proc. 2002-67, 2002-2 CB 733 (settlement procedures relating to contingent liability tax shelters)

Rev. Rul. 2003-56, 2003-1 CB 985 (netting of liabilities assumed by each party to § 1031 exchange for purposes of § 752)

Chief Counsel Guidance

PLR 7841011 (June 28, 1978) (in shareholder derivative suit arising out of merger of one mutual fund management company into another, individual officers paid a judgment, either in cash or stock; payment not an adjustment to merger consideration and deductible as ordinary income; the fact that stock was used to satisfy the judgment)

AOD 1981-115 (Apr. 27, 1981), *modifying* O.M. 70587 (May 16, 1980) (acquiescence in *VCA Corp. v. United States*)

GCM 38977 (Apr. 8, 1982) (discussing Rev. Rul. 83-73)

PLR 9715008 (Dec. 4, 1996) (contingent payments in redemption of partnership interest allocated between principal and interest)

TAM 9716001 (June 17, 1996) (after transfer by Target of business to Parent under § 351, Parent paid vacation pay accrued to Target's employees and was reimbursed by Parent; Parent may deduct payments under § 404(a); reimbursement not income to Parent and does not reduce deduction)

FSA 199905008 (Oct. 29, 1998), reconsidered by FSA 199929015 (Apr. 20, 1999) (consolidated group members transferred cash and other assets to Newco, which assumed contingent tort liabilities and then sold Newco stock at a loss; Rev. Rul. 95-74 could apply, but National Office recommends arguing that § 351 did not apply to asset transfer because of no business purpose)

PLR 199919025 (May 14, 1999) (in connection with divisive type-D reorganization, payments between distributing and spun-off corporations for environmental and other liabilities not fixed and determinable at time of spin-off treated as occurring immediately before spin-off; query: Is this conclusion consistent with Rev. Rul. 95-74 (which suggests that spun-off corporation would deduct the indemnity payment when made to distributing payment))

TAM 200006014 (Oct. 22, 1999) (loss on sale of subsidiary stock disallowed under Reg. § 1.1502-20 where parent transferred intercompany debt instruments to subsidiary, and subsidiary assumed contingent liabilities for parent's employee benefits; extensive analysis of Reg. § 1.1502-13(g); *compare* FSA 200128014 (Apr. 10, 2001))

FSA 200008012 (Nov. 8, 1999) (insolvency of Target does not prevent merger from qualifying as reorganization under § 368(a)(1)(A) where the shareholders of the insolvent corporation receive a proprietary interest in exchange for the corporation's assets)

FSA 200121013 (Feb. 12, 2001) (in calculating basis in stock of subsidiary, parent must offset cash transferred to subsidiary by present value of nonqualified deferred compensation liabilities assumed by subsidiary; § 357(c)(3)(A) does not apply because parent remained entitled to take the deduction arising from payment of liabilities subsequent to the exchange)

FSA 200133006 (Apr. 11, 2001) (transfer to controlled corporation of note and obligation to pay rent in same amount treated as payment to discharge rent obligation, not § 351 exchange)

CCA 200117039 (Apr. 27, 2001) (obligation to pay rent in lease strip not subject to § 357(c)(3), loss on sale of stock issued in transaction where this obligation assumed disallowed, even if exchange occurred before effective date of § 358(h))

FSA 200134008 (May 15, 2001) (applying Notice 2001-17 to deny deduction for payments made on contingent employee benefit liabilities assumed in § 351 exchange)

FSA 200122022 (June 4, 2001) (consolidated group member transferred notes receivables to its subsidiary in exchange for subsidiary's assumption of risk management liabilities and voting preferred stock of subsidiary; loss on subsequent sale of preferred stock disallowed under reasoning of Notice 2001-17; alternatively, loss on stock sale disallowed by Reg. § 1.1502-20)

Notice CC-2001-033a (June 26, 2001) (review of issues in contingent liability tax shelters discussed in Notice 2001-17)

PLR 200218019 (May 3, 2002) (nuclear power company is eligible and electing taxpayer under Reg. §§ 1.468A-1(b) and 1.468A-2, respectively, and pursuant to a § 351 restructuring transaction, liability for decommissioning expenditures is transferred to partnership/division of company)

CCA 201023056 (Sept. 22, 2009) (spun-off corporation in divisive type-D reorganization may deduct payment of contingent liability assumed from its parent, under same theory as Rev. Rul. 95-74; § 1341 relief not available)

Commentary

See also commentaries cited in TAXABLE ACQUISITIONS – TAXABLE ASSET AND STOCK ACQUISITIONS – CONTINGENT PURCHASE PRICE, above.

ABA Section of Taxation, "Comments Regarding Liability Assumption Provisions in IRS Restructuring Bill," 1998 TNT 127-10

J. L. Cummings, "'Closed' and 'open' sales: A recommended alternative," Cummings' Corporate Tax Insights, Volume 01, No. 02 (Apr. 22, 2003)

N.Y.S. Bar Ass'n Tax Section Committee on Corporations "Report on Proposed Legislation to Amend Section 357(d)," 1999 TNT 18-15 (Jan. 22, 1999)

J. Blanchard & K. Hooker, "Fixing Assumption of Liability Rules: The Wrong Way and the Right Way," 85 Tax Notes 933 (Nov. 15, 1999)

M. Kliegman & J. Martin, "Whose Liability Is It Anyway? The Impact of Recent Amendments to Section 357," 91 J. Taxation 341 (Dec. 1999)
M. Banks-Golub, "Recent Amendments to Code Sec. 357: Congress Responds to 'Artificial Basis Creation,'" 78 TAXES 19 (May 2000)
J. Bogdanski, "Section 357(d) – Old Can, New Worms," 27 J. Corporate Taxation 17 (Spring 2000)
J. Schwartz, "When You Assume ... Rearranging Liabilities in Corporate Reorganizations," The Tax Club (Nov. 2001)
L. Sheppard, "Dissecting Partnership Gambits for Rich People," 96 Tax Notes 22 (July 1, 2002)
J. Kwall, "Out with the Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales," 81 N.C. L. Rev. 977 (March 2003)
D.C. Bar Ass'n Section of Tax'n, Corp. Tax Comm., "Comments on Advanced Notice of Proposed Rulemaking Concerning Assumption of Liabilities," (May 19, 2003) 2003 TNT 229-20
N.Y.S. Bar Ass'n Tax Section, Report No. 1051, Report on Treatment of Variable Stock Consideration in Tax-Free Corporation Reorganizations" (Feb. 4, 2004), 2004 TNT 25-12
M. Silverman, M. Lerner & G. Kidder, "The Economic Substance Doctrine: Sorting Through the Federal Circuit's 'We Know It When We See It' Ruling in Coltec," The Tax Executive (November - December 2006)
M. Jackel & R. Crnkovich, "Son-of BOSS Revisited," 123 Tax Notes 1481 (June 22, 2009)
R. Lipton, "No 'Bliss' in New Phoenix Sunrise—Tax Court Rejects and Penalizes a Tax Shelter Transaction," 111 J. Taxation 21 (July 2009)
M. Jackel, "Dawn of a New Era: Congress Codifies Economic Substance," 127 Tax Notes 289 (Apr. 19, 2010)
J. Cummings, "Economic Substance Doctrine Defense Plan," 130 Tax Notes 953 (Feb. 21, 2011)