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Tax Accounting Methods Considerations in Restructuring Transactions

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I. Tax Accounting Method Implications of Various Restructuring Transactions

This outline presents the tax accounting method implications of various restructuring transactions, including those described in Internal Revenue Code (Code) §§351, 338, 381, and 1001. It discusses the rules related to carrying over methods of accounting, obtaining audit protection through filing accounting method changes, preserving favorable methods of accounting, determining the effect of the transaction on unamortized Code §481(a) adjustments, and using the chosen structure as a means of achieving appropriate tax accounting method objectives. In addition, it describes some of the most common types of accounting method issues that arise during the course of due diligence, alternatives for mitigating exposure to the buyer, and anti-abuse rules that prevent taxpayers from unreasonably taking advantage of these provisions. Finally, it addresses some potential pitfalls that taxpayers should consider.

A. Taxable Sale of a Business

A taxable sale of a business may be accomplished through a taxable sale of stock or a taxable sale of assets constituting a trade or business. A taxable sale of assets may be accomplished by an outright sale of the assets or a deemed sale of the assets through an election under Code §338.

1. Taxable Sale of Stock (Seller)

A taxable sale of stock generally presents few tax accounting method issues to the seller. The seller has capital gain or loss on the sale equal to the difference between the tax basis in the stock and the proceeds of the sale.\(^1\) Also, because there has been no termination of the trade or business and no Code §381 transaction, pre-sale accounting methods and taxable years generally carry over. Two common tax accounting method issues that sellers encounter in a stock sale are: (1) pre-transaction method changes to optimize or to correct improper accounting methods, and (2) issues created by short tax years.

a) Pre-Transaction Method Changes (Optimize & Correct)

To the extent the target has historically used improper or unfavorable methods of accounting, it should consider affirmatively identifying and changing those methods prior to the purchaser’s due diligence and/or the sale. Purchasers typically evaluate a target’s accounting methods during due diligence and generally value permissible and favorable methods, while discounting impermissible or unfavorable accounting methods. A company that anticipates a future taxable stock sale should consider a thorough review of its existing accounting methods to optimize those methods and insulate itself from potential exposure created through impermissible methods of accounting. Filing a Form 3115, Application for Change in Accounting Method, will generally provide audit protection for impermissible accounting methods and a four-year spread of the adjustment that results from an unfavorable change.\(^2\) The deduction

\(^1\) Code §§1001 and 1222.

that results from a change to a more favorable accounting method, on the other hand, is taken into account through a Code §481(a) adjustment that is reflected in full in the year of change without regard to any short taxable year that may result under Reg. §1.1502-76(b). Taxpayers request permission of the IRS to change accounting methods by filing Form 3115 under the procedures set forth for advance consent or automatic consent.

b) Issues Created by Short Tax Years or Desired Changes in Tax Years

Short taxable years may arise when a target becomes a member of or leaves a consolidated group. Short periods cause an allocation of income and expenses between or among short periods that are created by the transaction under Reg. §1.1502-76. In addition, where the timing of the inclusion of an item of income or expense is dependent on proximity to or a relationship to a year-end, the short taxable year may result in the acceleration of income or the deferral of a deduction. For example, the target may lose the ability to defer advance payments under Rev. Proc. 2004-34 if income is deferred beyond the end of the taxable year following the year of receipt; the target may be unable to deduct deferred compensation using the 2½-month rule of §404(b) because an intervening short period separates the year of accrual from the year of payment; or the target may be precluded from taking advantage of the 12-month rule under Reg. §1.263(a)-4(f). The last two issues are illustrated below:

**EXAMPLE - Deductibility of Deferred Compensation Affected by Tax Year Closing**

Assume a calendar year taxpayer and a year-end bonus that is fixed and determinable at year end and paid by 3/15 following year-end. Absent a short period, this compensation would be deducted at 12/31 of the year preceding payment. If the taxpayer has a short period created by a transaction on 9/30, then any bonuses accrued at 9/30 will not be deductible in either the short period ended 9/30 or the short period ended 12/31 but instead is deductible in year 2 when paid.

**EXAMPLE - Deductibility of Prepaid Expenses Affected by Tax Year Closing**

Assume a calendar year taxpayer that is a member of an affiliated group filing a consolidated return that pays an insurance premium on a 12-month policy on 3/15 of year 1. On 9/1 of year 1, taxpayer's stock is sold in a taxable sale and taxpayer has a short period that ends on 9/1 and another that ends on 12/31 of year 1. Under Reg. §1.263(a)-4(f), taxpayer would have been permitted to deduct the premium in full on 3/15 under the 12-month rule if the stock had not been sold. As a result of the transaction, however, the insurance premium must be amortized over the 12-months beginning 3/15 of year 1.

2. **Taxable Purchase of Stock (Purchaser)**

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6. Notably, on April 11, 2011, the Treasury Department issued final regulations (T.D. 9522) under Code §1563 (Reg. §1.1563-1) clarifying when a corporation that satisfies the controlled group rules for stock ownership and qualification is considered a member of a controlled group. In particular, these rules address when to ignore a corporation's status as a component member in determining whether it is a member of a controlled group. The final regulations apply to tax years beginning on or after April 11, 2011.

7. 2004-1 C.B. 991. Rev. Proc. 2004-34 provides for the deferral of certain eligible advance payments to the next succeeding taxable year. Section 5.02(2) of Rev. Proc. 2004-34 generally treats a short taxable year of more than 92 days as a taxable year for these purposes.

The treatment of a stock purchase varies depending on whether the purchaser is an individual, a corporation, or a consolidated group, and whether the purchaser makes an election under Code §338. The tax accounting methods for the purchase of stock appear on first blush to present few issues.

The purchaser accounts for the cost basis of the stock. Basis will also include transaction costs that facilitate the purchase of the stock. Future expenses of the business will continue to be deductible regardless of whether they existed at the time of the purchase. As discussed above in the context of the seller, if the stock purchase results in a short tax year, recognition of deferred revenue may be triggered. Nonetheless, the methods of accounting employed by the corporation prior to sale generally will continue since for tax purposes the corporation continues to exist.

a) Accounting Method Changes

The purchaser may desire to change accounting methods of the acquired company either to obtain audit protection for prior years, to conform methods to those used by related companies for administrative ease, or to utilize a more favorable method of accounting. Regardless of the reason, such an accounting method change generally requires approval of the Commissioner. Such approval is obtained either through the advance consent procedure, Rev. Proc. 97-27, or the automatic consent procedure, Rev. Proc. 2011-14. Where applicable, Rev. Proc. 2011-14 provides the exclusive procedure for making an accounting method change. A careful review of each revenue procedure is necessary to ensure compliance with all of the applicable provisions.

b) Tax Year Changes

The acquired corporation will continue to file tax returns on the tax year previously used unless either the consolidated return regulations dictate a change to the taxable year of the parent of the consolidated group or the acquired company requests permission to change to another taxable year. Issues sometimes arise when an acquired company seeks to change to a new taxable year without first completing the taxable year that was in progress at the time of the sale. In 2007, the Service issued Rev. Proc. 2007-64, which addresses this and other issues. Specifically, a corporation that ceases to be a consolidated group member must continue to use the consolidated group's annual accounting period, unless it receives consent under Rev. Proc. 2002-39 to change its tax year or it is required to change its tax year upon joining another consolidated group.

c) Short Periods

A final issue the purchaser must address is how to determine the amount of income and expense that is allocable to each of the short periods when a company leaves a consolidated group, enters a consolidated group, or both. Reg. §1.1502-76(b) provides two possible methods—a closing of the books or a ratable allocation. Under the closing of the books approach, the selling company actually closes its books at the

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9 Code §1012.
10 See Reg. §1.263(a)-5. Also consider the applicability of Rev. Proc. 2011-29, 2011-18 I.R.B. 746, which provides for a safe harbor election, in lieu of the documentation described in Reg. §1.263(a)-5(f), for allocating transaction costs that are success-based fees between facilitative and non-facilitative activities.
11 Code §446(e).
12 1997-1 C.B. 680.
14 Reg. §1.1502-76(a)(1).
15 See, Reg. §1.441-1(e). See also Reg. §1.442-1(b)(1) which provides that a taxpayer requests permission to change to a new taxable year by filing Form 1128 under the applicable administrative procedures.
17 2002-1 C.B. 1046.
18 Rev. Proc. 2007-64 further provides that if a corporation ceases to be a member of the consolidated group during the group's first effective year, it is not a member of the consolidated group for purposes of the group's change in tax year.
end of the day of the sale and reports actual income and expense as of that day under its method of accounting. The purchasing company generally begins to report income and expense under the same methods of accounting from that point forward. Under the ratable allocation approach, income and expense for the entire year are allocated between the two short periods on a daily basis with special allocations of certain items (i.e., "extraordinary" items). The "extraordinary" items cannot be allocated on a daily basis; rather, each extraordinary item must be allocated to the day on which it is taken into account. The extraordinary items are listed in Reg. §1.1502-76(b)(2)(ii)(C) and include among other items, Code §481(a) adjustments arising from accounting method changes. Reg. §1.1502-76(b)(2)(ii)(D) provides that the election to ratably allocate items must be signed by the member and the common parent of each affected group and must identify the extraordinary items, their amounts and the returns in which they are included and the ratable amount to be ratably allocated. The regulations do not address the consequence if the elections reflect different amounts. Frequently, sale agreements include indemnification agreements that require the parties to take consistent tax positions. This type of item should be considered in negotiations of the sale to ensure that inconsistent positions do not create audit exposure for one party or the other.

One issue that arises regularly is how to address changes in method of accounting and the Code §481(a) adjustment when a taxpayer has a short period or periods. Short periods are treated as taxable years for all purposes of the Code. As a consequence, the seller may file a Form 3115 for the short period prior to the sale and the buyer may file a Form 3115 for the short period after the sale. In fact, sellers frequently file method changes before a transaction to obtain audit protection and buyers frequently change accounting methods after the sale to change to more favorable methods or methods that are consistent with those used by other members of the group. Thus, it is not unusual to see Code §481(a) adjustments in both the period before and the period after the sale. The Code §481(a) adjustment is one of the 14 extraordinary items listed in the regulations and will, as a consequence, be specifically allocated to the appropriate short period rather than apportioned under the ratable allocation approach.

3. **Taxable Sale of Assets (Seller)**

In a taxable asset sale, the seller determines gain on an asset-by-asset basis. The character of the gain will vary depending on the assets being sold. The seller includes liabilities assumed in sales proceeds even though such liabilities may not meet the "all events" test at the time of the sale. Reg. §1.461-4(d)(5) provides a special rule that permits an expressly assumed liability that is fixed and determinable as of the date of the sale to be taken into account by the seller at the same time that the seller includes the liability in the amount realized.

To the extent a liability of the selling corporation is not expressly assumed by the purchaser, the corporation generally must remain in existence to be assured of realizing a deduction when the liability ripens. If the corporation is liquidated before such liabilities ripen and the shareholder pays the liability on behalf of the corporation, the payment may generate a capital loss rather than an ordinary deduction.

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22. Code §481(a).
23. A taxable asset sale may be structured as a sale of the assets of the trade or business or a stock sale with a §338(h)(10) election. The former allows a purchaser to avoid assuming all liabilities of the trade or business while the latter presents more exposure to contingent liabilities. From a tax perspective, both transactions are treated the same.
24. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).
25. See §1231.
Similarly, if the remaining assets and liabilities are transferred into a liquidating trust, the same adverse result could ensue if the actual liabilities paid exceed estimated liabilities that are funded in the trust. Careful planning is necessary to ensure that the seller is permitted to deduct liabilities that accrue after a sale. The treatment of assumed contingent liabilities is dealt with in more detail later in this outline.

Situations involving the sale of the assets of businesses with deferred revenue warrant special consideration. Whether deferred under Rev. Proc. 2004-34, Code §455, Reg. §1.451-5, or another provision, deferred revenue may be triggered when the taxpayer receiving the advance payment is relieved of the obligation to perform in the future. Therefore, if the obligation to perform future services or provide goods in the future is assumed by the purchaser, the seller will likely have to accelerate the recognition of the previously deferred revenue. This may cause the seller to recognize more ordinary income and less capital gain from the transaction than initially contemplated. Relief from this harsh result was provided by the court in *James M. Pierce Corporation v. Commissioner* (hereinafter "Pierce"). In *Pierce*, the taxpayer sold its publishing business as part of a complete liquidation pursuant to Code §337. The sales price was reduced to compensate the buyer for assuming the seller's liability for unearned subscriptions (i.e., revenue deferred under Code §455). The court held that the reduction in sales price should be treated in the same manner as if the seller had received the gross amount from the buyer and then repaid the buyer with cash equal to the amount of the liabilities assumed. The court noted that this "payment" is considered to be separate from the underlying purchase of assets. Thus, the seller was required to accelerate the recognition of income previously deferred under Code §455 and received a deduction equal to the liabilities assumed by the buyer, which were compensated by the seller through a reduction in the purchase price.

In *Pierce*, the court determined that the liability assumed by the purchaser was equal to the amount of previously deferred revenue, the recognition of which was triggered by the sale. In practice, however, a question arises as to whether the amount of the deemed payment is equal to the seller's deferred revenue balance or the estimated cost to fulfill the obligation under the contract generating the deferred revenue. Arguably, the rationale in *Pierce* is sufficiently broad to encompass either of these alternatives. Through careful planning, sellers are often able to structure a transaction to ensure a deduction equal to the deferred income that is triggered by the transfer. This is illustrated in the example below:

**EXAMPLE - Seller's Treatment of Deferred Revenue in a Taxable Asset Sale**

On 6/30/09, S, a calendar year corporation, sells all of the assets of its magazine subscription business to P for $1,000, plus P's assumption of S's subscription liability. S has historically deferred subscription revenue for federal income tax purposes under Code §455. On 6/30/09, S has a deferred subscription liability for federal income tax purposes of $100. Under Code §455, S recognizes $100 ordinary income attributable to the deferred

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27 Reg. §301.7701-4(d). A liquidating trust is organized for the primary purpose of liquidating and distributing the assets transferred to it. Such trusts are treated as trusts for all purposes of the Internal Revenue Code.


29 Code §455 generally provides that that taxpayer engaged in the business of providing a newspaper, magazine or other periodical may elect to defer recognition of prepaid subscription income over the period to which the subscription relates.

30 Reg. §1.451-5 generally provides a limited deferral for income from an advance payment for the sale of goods, or for the building, installing, constructing, or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.


32 Section 5.02(5)(b) of Rev. Proc. 2004-34 requires a taxpayer to accelerate recognition of advance payments if and to the extent that the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends in a transaction other than a transaction to which Code §381(a) or §351 applies. See also Code §455(b)(1) and Reg. §1.451-5(f).

33 326 F.2d 67 (8th Cir. 1964).

revenue. Under the Pierce rationale, S arguably would be entitled to a $100 ordinary deduction, and would recognize sales proceeds of $1,100.

The sale of the assets of the business may also include the sale of a long-term contract. The regulations under §460 include special rules to account for mid-contract changes in ownership of long-term contracts that are subject to Code §460. Under this provision, the seller of a contract is treated as having completed the contract on the date of sale and must re-compute income under the contract. As a consequence, a profitable contract may be reported as a loss contract if payments are in arrears. An unprofitable contract may be reported as profitable if payments are made in advance of when costs are incurred.

4. **Taxable Purchase of Assets or Stock with a Code §338(h)(10) election**

Generally, if the parties to a stock purchase make a valid election under Code §338(h)(10), the stock purchase is treated as a deemed asset purchase for federal income tax purposes. Specifically, the target corporation ("OT") is treated as selling its assets to a new target corporation ("NT"), owned by the purchasing corporation and then liquidating and distributing the sale proceeds to its shareholders. Note that certain rules applicable to Code §338 deemed asset purchases also apply to Code §1060 actual asset acquisitions. For example, the rules under Code §338 relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a Code §338 election is made apply in the case of applicable asset acquisitions under Code §1060. NT is generally treated for federal income tax purposes as a new corporation, unrelated to OT, which purchases the assets of OT on the day after the acquisition date. Thus, NT is not considered related to OT for purposes of Code §168, and may make new elections under Code §168 without taking into account the elections made by OT. NT may adopt any taxable year that meets the requirements of Code §441 and any method of accounting that meets the requirements of Code §446, without obtaining prior approval from the Commissioner.

NT's ability to adopt new accounting methods presents opportunities to use the most tax-favorable methods, but also some possibly unexpected consequences resulting from OT's methods.

a) Methods Affected by Gross Receipts

Code §448 limits the ability of certain taxpayers to use the cash method of accounting. For example, a C corporation with average annual gross receipts for the three prior taxable years in excess of $5 million cannot use the cash method. This gross receipts test is applied taking into account gross receipts of predecessor corporations. The regulations under Code §338 are clear that NT has no predecessors. Consequently, NT applies the $5 million gross receipts test as if it had no predecessors. Thus, in NT's first

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35 See Reg. §1.460-4(k) and §1.460-6(g). The "constructive completion" rules in Reg. §1.460-4(k)(2) apply to transactions that result in a change in the taxpayer responsible for reporting income from a long-term contract. Generally, these transactions include taxable asset sales under Code §1001 and deemed asset sales under Code §338(b)(10).
36 Reg. §1.460-4(k)(2)(i).
37 Code §338(a).
38 Reg. §1.338(b)(10)-1(d).
39 See Reg. §1.1060-1(a)(1) (providing that in the case of an applicable asset acquisition under Code §1060, the transferor (seller) and transferee (purchaser) must each allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under Code §338(b)(5). Also, in the case of an applicable asset acquisition described in Reg. §1.1060-1(b)(1), sellers and purchasers must allocate the consideration under the residual method as described in Reg. §§1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.).
40 See Code §338(a)(2); Reg. §§1.338-1(a)(1) and (b)(1).
41 Reg. §1.338-1(b)(1)(i).
42 Reg. §1.338-1(b)(1)(ii).
43 Reg. §1.338-1(b).
year, it may be able to avoid the required use of the accrual method, because it is deemed to have no gross receipts for prior periods.\textsuperscript{44}

A similar gross receipts test (although the threshold is $10 million rather than $5 million) applies for purposes of Code §263A (the uniform capitalization provisions) and Code §460 (long-term contract accounting). Importantly, if NT has inventories, Code §471 and the regulations thereunder require the use of the accrual method to account for inventories regardless of the taxpayer's gross receipts.\textsuperscript{45}

\textit{b) Depreciation}

As noted above, NT is permitted to adopt new depreciation methods and make new depreciation elections with respect to the acquired assets.\textsuperscript{46} The acquired assets are generally considered placed in service on the acquisition date.\textsuperscript{47} If NT is included in a consolidated return, NT's first year Code §168 deduction will be subject to the applicable convention determined at the consolidated group level.\textsuperscript{48}

In the case of a consolidated group, all members included in the consolidated return are treated as one taxpayer for purposes of determining whether the mid-quarter convention applies to property placed in service during the consolidated return year (i.e., in applying the "40% test").\textsuperscript{49} Thus, the depreciable bases of all property placed in service by members of a consolidated group during a consolidated return year are taken into account (unless otherwise excluded) in applying the 40% test.\textsuperscript{50} In the case of a corporation formed by a member of the consolidated group (a "newly-formed subsidiary"), the depreciable bases of property placed in service by the newly-formed subsidiary during the consolidated return year in which it is formed is included with the depreciable bases of property placed in service during the consolidated return year by the other members of the consolidated group in applying the 40% test.\textsuperscript{51} If the newly-formed subsidiary places depreciable property in service during the consolidated return year in which it is formed, it is considered as being in existence for the entire consolidated return year for purposes of the applicable convention for determining when the recovery period begins.\textsuperscript{52} This is illustrated in the example below:

\textbf{EXAMPLE 1 - MACRS Depreciation Conventions}

On 1/1/09, NT, a wholly owned consolidated subsidiary of calendar year P, acquires the stock of OT. The parties make a Code §338(h)(10) election. As a result of the Code §338(h)(10) election, NT is deemed to have purchased tangible personal property eligible for MACRS of $1 million. In addition, during 12/09, P placed in service tangible personal property totaling $500,000. No other assets were acquired and/or placed in service. Thus, the P consolidated group placed $1,500,000 of assets into service during 2009. The 40% test is determined at the consolidated level and indicates that 33% of the assets placed in

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\textsuperscript{44} NT may still be required to use the accrual method under Code §448 if, under the aggregation provisions of Reg. §1.448-1T(f)(2)(ii) relating to all persons treated as a single employer, NT fails the $5 million gross receipts test. If NT is eligible to use the cash method for its first taxable year, it would likely be required to change its method of accounting effective the next taxable year. Such change would be made in accordance with Reg. §1.448-1(b).


\textsuperscript{46} Reg. §1.338-1(b)(1)(i).

\textsuperscript{47} Note that the assets acquired in a §338(h)(10) transaction are generally not eligible for bonus depreciation under Code §168(k) as NT does not satisfy the original use requirement of Code §168(k)(2).

\textsuperscript{48} Reg. §1.168(d)-1(b)(5). See also IRS Letter Ruling 199944006 (7/20/99) (taxpayer's newly formed subsidiaries deemed to have been in existence for the entire consolidated return tax year).

\textsuperscript{49} See Reg. §1.168(d)-1(b)(5)(i) for details on the 40% test.

\textsuperscript{50} Id.

\textsuperscript{51} Reg. §1.168(d)-1(b)(5)(ii).

\textsuperscript{52} Id.
service in 2009 [$500,000/$1,500,000] were placed in service in the fourth quarter. Accordingly, the mid-quarter convention does not apply.

c) Inventories
NT may adopt any inventory method that clearly reflects income. If NT wants to use LIFO, it must make the election by timely filing Form 970. If the purchase price allocated to inventory reflects a bargain purchase price, such bargain inventory may be considered a separate item for LIFO accounting purposes.53

d) Deferred Revenue
As noted above, the selling and purchasing parties must jointly elect under Code §338(h)(10).54 Neither the Code nor the regulations, however, specifically require the purchaser and seller to agree on the amount of consideration each reports.55 In some cases, the seller and purchaser may not agree on the amount and/or allocation of the purchase price. For example, where the seller has deferred revenue, an issue often arises how to treat NT's assumption of the liability associated with the deferred revenue.

An accrual basis taxpayer generally recognizes income at the earliest of when due, received, or when earned.56 However, an accrual method taxpayer that receives advance payments may, in certain circumstances, defer recognition of income.57 Under the various statutory, regulatory, and administrative provisions, the taxpayer must continue to be obligated to perform under the agreement to be entitled to deferral.58 Because the seller in a Code §338(h)(10) transaction generally transfers its obligation to perform under the agreements giving rise to the deferred revenue, the seller will be required to recognize previously deferred amounts.

As discussed in detail above, a seller relying on James M. Pierce Corp. v. Commissioner,59 may claim a deduction for amounts deemed (or actually) paid to the purchaser (or NT) to assume its obligation with respect to the deferred revenue. Although in Pierce, the court determined that the liability assumed by the purchaser was equal to the amount of previously deferred revenue recognition of which was triggered by the sale, in practice a question arises as to whether the amount of the deemed payment is equal to the seller's deferred revenue balance, the cost to fulfill the obligation under the contract generating the deferred revenue, or the fair market value of the performance under the contract. Arguably, the rationale

54 Reg. §1.338(h)(10)-1(c)(2).
55 Such a requirement could possibly be inferred from the joint election requirement under Reg. §1.338(h)(10)-1(c)(2). Thus, it appears that purchaser and seller may report a different sales price on Form 8023 without affecting the validity of the election under Code §338(h)(10). It is unclear, however, what audit risks may result to both the seller and the purchaser in this event.
57 Sec, e.g., Rev. Proc. 2004-34, 2004-1 C.B. 991, which provides a one-year deferral for certain advance payments; Reg. §1.451-5, which provides for the deferral of certain advance payments received for the sale of goods by the taxpayer; Code §455, which provides for the deferral of advance subscription payments; and Code §456, which provides for the deferral of certain advance membership fees.
58 Section 5.02(5) of Rev. Proc. 2004-34 provides in relevant part that advance payments previously not included in gross income are taken into account in the taxable year the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends. An exception is provided for "a section 351(a) transfer in which (a) substantially all assets of the trade or business (including advance payments) are transferred, (b) the transferee adopts or uses the Deferral Method in the year of transfer, and (c) the transferee and the transferor are members of an affiliated group of corporations that file a consolidated return." Reg. §1.451-5(f) provides "if a taxpayer has adopted a method prescribed in paragraph (b)(1)(ii) of this section, and if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year." See Reg. §1.455-4 for a similar provision for deferred subscription revenue.
59 326 F.2d 67 (8th Cir. 1964), rev'd 38 T.C. 643 (1962).
in Pierce is sufficiently broad to encompass any of these alternatives. Thus, a seller may rely on Pierce to support treating the deemed payment as equal to the deferred revenue; while the purchaser (or NT in a §338(h)(10) transaction) treats the deemed payment as equal to its estimated cost to fulfill the obligation under the contracts. The disparate treatment would result in differing purchase prices reflected by the seller and NT.

The court in Pierce did not specifically address the treatment of the purchaser (i.e., NT in a Code §338(h)(10) transaction). However, based on relevant authorities, when a buyer assumes a liability associated with deferred revenue of the seller there appear to be three possible approaches to analyze the tax consequences to the buyer. First, there are authorities indicating that a deferred revenue liability is treated the same as any other assumed liability—that is, it is capitalized to the basis of the acquired assets when it is economically performed (the "assumed liability approach"). Second, in situations where the seller makes a separate cash payment to the buyer, the transaction is bifurcated into two components: (1) the purchase of assets; and (2) a separate payment to the buyer for the buyer's agreement to perform the seller's prepaid subscription liability (the "bifurcation approach"). Finally, in situations where the seller and the buyer reduce the purchase price, the IRS has applied the bifurcation approach to treat the transaction as (1) the purchase of assets; and (2) a deemed separate payment by the seller to the buyer in the amount of the purchase price reduction to the buyer for the buyer's agreement to perform the seller's liability (the "deemed payment approach"). This is addressed in more detail in the contingent liability section below.

Moreover, in Rev. Rul. 71-450, (the "bifurcation approach") the Service explained that the purchaser would have income upon receipt of the payment from the seller. In that ruling, the Service concluded that the amount paid by the seller of a newspaper to the purchaser who assumed liability for unearned subscriptions is includible in the purchaser's gross income. Although not contemplated by the ruling, the purchaser should be able to defer the income resulting from the payment from the seller under the applicable statutory, regulatory, or administrative procedure. In addition, NT possibly could argue that Rev. Rul. 71-450 is distinguishable because the facts of the ruling indicate that under the terms of the asset purchase agreement, the seller paid the buyer an amount to assume its pre-existing subscription obligation (i.e., there was an actual rather than deemed payment as was the case in Pierce). Nonetheless, applying the rationale in Pierce would tend to indicate that the distinction between an actual and a deemed payment is not relevant in determining the tax treatment.

None of the guidance addresses the treatment of the costs NT will incur to satisfy its obligation. Arguably, under the Pierce rationale and Rev. Rul. 71-450, NT should treat such costs as period expenses deductible as incurred. This treatment, however, is not as clear if NT does not recognize the advance

60 See Rev. Rul. 76-520, 1976-2 C.B. 42; FSA 20048002 (5/22/00); FSA 1999841.
63 1971-2 C.B. 78.
64 Under the facts of the ruling, the seller received 5x dollars as the sales proceeds, which did not take into account the seller's liability for existing newspaper subscriptions. The seller paid the purchaser 1x dollars, a sum equal to the amount of prepaid subscriptions existing at the time of the sale, to compensate the purchaser for assuming the seller's liability on the subscriptions. Under these facts, the Service concluded that the buyer had gross income under Code §61 equal to the 1x dollars it received from the seller.
65 This is the conclusion the Service appears to have reached in Gen. Coun. Mem. 34418 (2/3/71).
66 Cf. Rev. Rul. 76-520, 1976-2 C.B. 42, wherein the taxpayer assumed an obligation to fulfill existing subscription contracts as part of the liquidation of its subsidiary. In its final year, the subsidiary included the prepaid subscription revenue in gross income. The IRS concluded that the costs incurred by the taxpayer subsequent to the liquidation (which was governed by prior law §334(b)(2)) to fulfill the prepaid subscription contracts entered into by the subsidiary were properly capitalized as additional basis in the assets the taxpayer acquired. In reaching its conclusion, the IRS noted that, "[c]osts incurred by the acquiring corporation in satisfaction of a liability of the acquired corporation assumed by the
payment (whether by including in income or deferring under the applicable provision) in the year of the purchase. For example, the buyer may value the deferred revenue obligation based on the sum of the net present value of the estimated costs to perform under such obligation plus a reasonable profit margin, and increase its basis in the assets purchased accordingly. A variation of this treatment would be for NT to record a liability for the cost to perform under the deferred revenue obligation as an assumed liability and increase the basis in the assets acquired. In this case, NT would not recognize income as the liability is fulfilled, because it is not applying the Pierce fiction. Instead, as NT incurs costs to perform, it would reduce the assumed liability. The deduction would be reflected in the recovery of the basis of the assets to which the additional purchase price was allocated.

**EXAMPLE 2 - Deferred Revenue Obligation Assumed by Purchaser**

Assume P acquires the stock of T and jointly makes a Code §338(h)(10) election with Seller. Assume further that T received advance payments for services of $100X that it has deferred under Rev. Proc. 2004-34. P has determined that its obligation to perform the services will cost $50X. NT records a liability of $50X and increases its basis in the assets acquired by $50X. As NT incurs the costs to provide the services, it reduces the liability recorded at purchase, with no adjustment to income in such year. The recovery of the $50X added to basis is determined based on the particular asset to which the additional proceeds were allocated in accordance with Code §1060, and the regulations thereunder.

Perhaps an alternative to Pierce would be to treat the deferred revenue in a Code §338(h)(10) transaction (or a taxable asset acquisition) in a manner similar to the constructive completion method set forth in the final Code §460 regulations. These regulations apply to long-term contracts and generally require a constructive completion approach to certain mid-contract changes. Applying such a method in the deferred revenue context would cause the seller to treat the contract as completed in the year of the sale. Because all income is received in advance of incurring the costs, the seller would be taxed on the income and would not receive the corresponding deduction that was permitted under Pierce. The purchaser (or NT in a Code §338(h)(10) transaction) would simply deduct the costs of performing under the contract as incurred. This approach eliminates the need for the deemed payment and also requires the party receiving the advance payment to recognize the income. The Pierce rationale, by contrast, seems to shift the consequence of the transaction to the purchaser—both the income and the expense associated with fulfilling the obligation—and further to assume that such shift was taken into account in determining the overall purchase price.

As is evident from the above discussion, the treatment of deferred revenue in a §338(h)(10) transaction will continue to present opportunities and potential exposure until the Service provides clear and consistent guidance for the treatment by both the seller and NT. Moreover, as more taxpayers take advantage of the liberalized deferral provisions of Rev. Proc. 2004-34, the issue will arise more frequently raising the likelihood of purchase price allocation differences between purchasers and sellers.

**B. Code §351 Transaction**

In a Code §351 transaction, the transferee generally takes a carryover basis in the assets and steps into the shoes of the transferor with respect to the liabilities received in the transfer. With few exceptions, neither the transferor’s accounting methods nor accounting period carry over to the transferee. The transferee generally may adopt any permissible method of accounting and any permissible accounting period.

Several accounting method issues may arise in connection with a Code §351 transaction including acceleration of the recognition of deferred revenue, loss of accelerated deductions, and acceleration of

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acquiring corporation as part of the acquisition costs must be capitalized and added to the basis of the acquired assets rather than currently deducted."

67 Reg. §1.460-4(k).
previously unrecognized positive Code §481(a) adjustments. In addition, the transferee may take a
carryover basis that was computed using an impermissible method of accounting. Each of these issues is
discussed in more detail in this chapter.

1. Treatment of Transferor in a Code §351 Transaction

Code §351(a) provides, in pertinent part, that "[n]o gain or loss shall be recognized if property is
transferred to a corporation by one or more persons solely in exchange for stock in such corporation and
immediately after the exchange such person or persons are in control ... of the corporation." The
transferor's basis in the stock received is the same as the basis in the property transferred.\(^{68}\)

Although the Code §351 transaction itself is generally tax-free, the transferor may be required to
accelerate income recognition or lose the benefit of accelerated deductions as a result of the transaction.

a) Acceleration of Deferred Revenue

In general, an accrual basis taxpayer recognizes income at the earliest of when due, received or when
earned.\(^{69}\) However, as previously stated, an accrual method taxpayer that receives advance payments may,
in certain circumstances, defer recognition of income.\(^{70}\) Under various statutory, regulatory and
administrative provisions, the taxpayer must continue to be obligated to perform under the agreement to
be entitled to deferral.\(^{71}\) Because the transferor in a Code §351 transaction generally transfers its
obligation to perform under the agreements giving rise to the deferred revenue, the transfer will usually
trigger recognition of previously deferred amounts.

If the deferred revenue is triggered, the question becomes what amount, if any of the costs associated with
the deferred revenue are deductible by the transferor to offset the income recognition. The Service has
addressed this issue in a 1977 letter ruling\(^{72}\) and several General Counsel Memoranda.\(^{73}\) For example, in
Gen. Coun. Mem. 39413, the Service discussed the issue of whether the transfer of property to a
controlled corporation under Code §351 accelerated the recognition of prepaid subscription income
defered under Code §455 and whether the transferor was entitled to a deduction or offset for expenses to
be incurred in the future by the transferee in fulfilling the subscription contracts. The memorandum
concluded that although the income must be accelerated, there was no support for a corresponding
deduction by the transferor. This holding is somewhat questionable if the transferor remains in existence.
There is no novation of the contract, so the transferor remains obligated for the liability in which case
tere is no transfer of the liability.

In reaching its conclusion, the Service distinguished both the holding in *James M. Pierce Corporation. v. Commissioner*,\(^{74}\) which permitted a taxpayer to take a deduction under Code §162 for a deemed payment
to the transferee as compensation for the transferee assuming transferor's obligation to fulfill the
contracts, and a similar conclusion reached in Rev. Rul. 68-112\(^{75}\) based on the fact that both *Pierce*
and the ruling involved outright sales to third parties. The memorandum notes that since the transferee will be
treated as a separate taxpayer from transferor and the future expenses related to the contracts will be
incurred by the transferee, then there is no authority supporting such a deduction of the expenses by
transferee. The Service effectively views the court's approach in *Pierce* (deemed payment by the seller to
the purchaser to assume the obligation to perform under the agreements giving rise to the deferred
revenue) as inconsistent with a carryover basis transaction.

\(^{68}\) Code §358(a)(1). This assumes the simplest scenario where property is exchanged solely for stock and there is no boot.

\(^{69}\) Id. at footnote 56.

\(^{70}\) Id. at footnote 57.

\(^{71}\) Id. at footnote 58.

\(^{72}\) IRS Letter Ruling 771229990A (12/20/77).


\(^{74}\) 326 F.2d 67 (8th Cir. 1964).

\(^{75}\) 1968-1 C.B. 62.
No court has yet considered whether the approach taken by the court in Pierce should apply equally to a Code §351 transaction. Although an argument might be made that Pierce is equally applicable in a Code §351 transaction as well as in an asset sale, the ability to sustain such a position is uncertain in light of the Service's position in Rev. Rul. 68-112. To avoid this uncertainty, transferors may want to consider structuring a Code §351 transaction to achieve a similar result by expressly providing for an actual payment to the transferee to cover the cost of performing under the contract. In addition, if the transferor remains in existence, it should remain obligated on the contract until all deferred revenue is recognized. The payment to the transferee as a general matter should generate a deduction under Code §162. If the transferor continues in existence and remains obligated on the contract, it may be able to continue to defer the revenue. In this latter case, the timing of the deduction will be subject to Code §§263(a) and 461(h).

b) Effect on Transferor's Deductions

Another issue that routinely arises is the appropriate application of the transferor's established method of accounting in the final year of the trade or business. This issue can occur where an accrual method transferor transfers a liability that meets the all events test for which economic performance is payment and the transferor employs the recurring item exception. It can also arise in the context of deferred compensation that has economically accrued but has not been deducted, because it is subject to the 2½-month rule of Code §404.76

In IRS TAM 9716001, the Service addressed whether a transferee in a Code §351 transaction was entitled to a deduction under Code §162 for payments it made to satisfy a vacation pay liability of the transferor that the transferee assumed in the exchange.77 In that ruling, a corporation (the transferor) transferred substantially all of its assets and liabilities to a newly formed subsidiary (the transferee) in a Code §351 transaction. Among the transferred liabilities was a liability for accrued vacation pay owed to employees. Subsequent to the exchange and more than 2 and ½ months after the end of the transferor's tax year, the transferee paid the compensation to the transferred employees. In holding that the transferee could deduct the vacation pay in the year that it paid the accrued liability, the Service noted that:

Since the Vacation Payments were paid to the transferred employees during a period more than two and a half months after the year in which the employees earned the vacation pay, the Vacation Payments are deferred compensation. Accordingly, the deductibility of the Vacation Payments is subject to sections 404(a) and 404(a)(5) ... Accordingly, under sections 404(a) and 404(a)(5), [the transferee] can deduct the Vacation Payments only if (1) such payments are deductible by [the transferee] as an ordinary and necessary business expense under section 162, and (2) the deduction is taken in Year X, [the year paid].

The Service found that the transferor transferred substantially all of its assets and liabilities to the transferee, the vacation pay would have been deductible by the transferor if paid by the transferor, and the transferor transferred the accrued vacation liability to the transferee for a valid business purpose. Accordingly, the Service concluded that the transferee was entitled to the deduction. The Service noted that, the Congressional intent in enacting Code §351 (to facilitate necessary business adjustments) would be frustrated by prohibiting the subsidiary from claiming a deduction attributable to expenses of the ongoing business.

A similar rationale should apply where the transferee makes a payment on transferred liability that satisfied the all events test under Code §461 at transfer and payment satisfies the economic performance requirement under Code §461(h). If the transferor uses the recurring item exception with respect to the item and payment is made by the transferee (generally within 8½ months of the end of the transferor's taxable year), the transferor should be entitled to the deduction.

76 Temp. Reg. §1.404(b)-1T, Q&A-2(a).
77 6/17/96.
The holding in IRS TAM 9716001 may provide some flexibility in managing state net operating loss carryovers or net operating loss carryovers limited by the separate return loss year ("SRL Y") rules. By timing the payment of the compensation or payment liability, a taxpayer determines whether the transferor or transferee is entitled to the deduction. As noted above, this only applies for liabilities that meet the all events test (i.e., are fixed and determinable) prior to the transfer, liabilities subject to the 2½ month rule under Code §404 or possibly liabilities for which payment satisfies the economic performance requirement, and where there is a valid nonfederal income tax business purpose for the Code §351 transaction.

Finally, there is no authority that would permit a deduction in these situations for a cash basis transferor. The only way of securing a deduction for such liabilities is for the transferor to remain in existence long enough to pay the liabilities and claim the deduction. It may be possible for the transferor to accelerate a deduction by filing a Form 3115 to change from the cash to the accrual method but such change will not secure a deduction for liabilities that do not meet the all events test. As discussed earlier, such Form 3115 would likely need to be filed for the year before the year in which the Code §351 transaction occurs. Note that if the transferor does not remain in existence, it is unlikely consent for the change will be granted.

c) Acceleration of Prior Years' Positive Code §481(a) Adjustments

Unamortized Code §481(a) adjustments generally are accelerated if the transferor terminates its existence or ceases to engage in a trade or business. For this purpose, a taxpayer is deemed to have ceased to engage in a trade or business "if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer." The term "substantially all" for this purpose is defined in §3.01 of Rev. Proc. 77-37 as "assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer." A limited exception is provided for Code §351 transfers to a member of a consolidated group if the transferee continues to use the same method of accounting as the transferor.

d) Transferor's Erroneous Accounting Methods

Once a Code §351 transaction has been consummated, the transferor generally will be unable to secure either an accounting method change requiring advance consent of Service under Rev. Proc. 97-27 or one under the automatic consent provisions of Rev. Proc. 2011-14. The scope restrictions in Rev. Proc. 2011-14 prevent taxpayers from filing most accounting method changes under Rev. Proc. 2011-14 in the final year of business. In addition, the IRS National Office routinely denies a taxpayer's request to change its method of accounting in its final year of existence as not in the interest of sound tax administration. Therefore, unless the corporation remains in existence following the transfer and continues the trade or business to which the method change relates (with over 10% of the fair market value of net assets or 30% of the fair market value of gross assets in the case of a method change under Rev. Proc. 2011-14), it may not be possible, under either Rev. Proc. 97-27 or 2011-14, for the corporation to file a Form 3115 to...
change from an erroneous to a proper method of accounting and obtain audit protection for prior years. Consequently, it is advisable for taxpayers contemplating a Code §351 transaction to review accounting methods in a taxable year prior to the anticipated transaction so that any necessary accounting method changes may be requested in advance of the final year of the taxpayer.

2. Treatment of Transferee in Code §351 Transaction

A newly formed corporation may adopt accounting methods that are generally applied prospectively to income earned and liabilities incurred from the contributed assets. For example, in Rev. Rul. 80-198, a cash basis individual transferred all of the assets and liabilities of a sole proprietorship to a new corporation in exchange for stock of the corporation in a transaction qualifying under Code §351. The Service held that the transferee corporation must report in its income the accounts receivable as collected and will be allowed deductions under Code §162 for payments made to satisfy accounts payable. According to the Service, to allow otherwise would frustrate Congressional intent to allow for tax-free incorporation under Code §351. The Service noted, however, that the ruling’s application is limited to those transactions that do not have a tax avoidance purpose.

If the transferee has previously been in existence and has adopted methods of accounting for items transferred, those methods survive, i.e., there is no Code §381-type analysis to determine the principal method. In addition, Code §§168(i)(7) and 197(f)(9), respectively require both new and previously existing transferees to "step-into-the-shoes" of the transferor to the extent of the carryover basis for purposes of determining the depreciation method, recovery period, and convention under Code §168 and amortization under Code §197.

A number of issues arise in accounting for the assets and liabilities transferred in a Code §351 transaction, including those with a zero basis on the opening balance sheet, because the transferor was on the cash method of accounting.

a) Transferee Succeeds to Liability Incurred by Transferor

If the transferee is an accrual basis taxpayer and pays a liability that accrued prior to the transfer but was not taken into account because the transferor used the cash method, a question arises as to whether the transferee can claim the deduction. In this situation, transferees generally may deduct the payment of such liabilities at the time of payment if they would have been deductible by the transferor. If the transferor is an accrual method taxpayer, the timing of the payment by the transferee may affect whether the transferor or transferee is entitled to claim the deduction.

b) Transferee Succeeds to LIFO Inventories

If the transferor used the last-in, first-out (LIFO) method and the transferee does not use the LIFO method, the transferor's LIFO layers are collapsed into a single layer reflected at average cost. This is the
case whether the transferee is an existing non-LIFO corporation or is a newly-formed corporation that has not adopted a method of accounting for inventory. However, the IRS is reconsidering this position where a newly-formed transferee elects to use the LIFO method.

If the transferee is an existing corporation that uses the LIFO method, the layers transferred from the transferor are merged with those of the transferee. The transferor's layers from years prior to the transferee's base year will be collapsed into a new base year layer. This is the conclusion reached in *Joseph E. Seagram & Sons v. Commissioner.* In that case, the parent, for valid business reasons, contributed a portion of its inventories to a wholly-owned subsidiary. Both the parent and subsidiary used the LIFO method to value the inventories before and after the transfer. The Service asserted that the LIFO cost and the LIFO layers and basis of the parent's inventory should carry over to the subsidiary. The taxpayer argued that Code §381(a) should not be applicable as the transaction was a §351 transfer; and therefore, the layers should be aggregated and treated as a single acquisition using average cost. Both agreed that the basis in the inventories was the carryover basis from the transferor. The Tax Court agreed with the taxpayer. The Second Circuit, however, reversed and held in favor of the Service. The Second Circuit reasoned that generally accepted accounting principles ("GAAP") were a controlling factor in the accounting for the transaction. The court noted that GAAP does not accord independent financial significance to a capital contribution. GAAP requires that a transferor's LIFO layers be integrated with the transferee's layers.

The Service followed the *Seagram* decision in Rev. Rul. 70-565, holding that a corporation using the LIFO inventory method, which acquires LIFO inventories in a Code §351 exchange, must integrate the acquired LIFO inventories into its own monthly LIFO layers using the original acquisition dates and costs of the transferor.

Often, taxpayers fail to make a LIFO election properly following a Code §351 transaction. The Service routinely grants relief under Reg. §301.9100 for late LIFO elections in this circumstance. The transferee makes the LIFO election on Form 970, which must be filed with the first return of the transferee. As part of making this election, the transferee may elect any proper method.

c) Transferee Succeeds to Long-Term Contracts of the Transferor

Reg. §1.460-4(k)(3)(i)(D) provides that in a Code §351 transaction the transferee steps into the shoes of the transferor with respect to any long-term contract. Under the regulations, the transferor's obligation to account for the contract terminates on the date of the transaction and is assumed by the transferee. The new taxpayer assumes the old taxpayer's method of accounting for the contract, and the contract price and allocable costs are based on amounts realized by both parties. The transferee will apply the look-back method only upon contract completion. The transferee must account for pre- and post-transaction years, and special rules apply to the calculation of look-back interest with respect to pre-transaction years. The transferor must provide information needed by the transferee to make the look-back calculations.

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89 See Rev. Rul. 70-564, 1970-2 C.B. 109, wherein the Service held that a new corporation or an existing corporation not using LIFO that acquires LIFO inventories in a Code §351(nontaxable exchange and desires to adopt the LIFO method determines opening inventory for the year of change by the average cost method. The Service based its holding on the language of Code §472(b)(3), which in relevant part provides that in inventoring goods specified in the application to use the LIFO method, the taxpayer shall treat those goods included in the opening inventory of the taxable year in which such method (LIFO) is first used as having been acquired at the same time and determine the cost of the goods using the average cost method. The Service further held that the transferee was required to file a Form 970 to elect LIFO.
90 21 A.F.T.R.2d 1189 (2d Cir. 1968).
92 See e.g., Textile Apron Co. v. Commissioner, 21 T.C. 147 (1953).
93 Code §460(f). (providing "the term "long-term contract" means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.").
94 Reg. §1.460-4(k)(3)(i).
Under the step-into-the shoes requirement, the transferee continues to use the transferor's accounting method for income and expense recognition until it obtains consent of the Commissioner to change such methods. Changes to long-term contract accounting methods under Code §460 are generally made on a cut-off basis. As a consequence, the method of accounting for long-term contracts subject to the mid-contract change of ownership rule will be unaffected by a subsequent accounting method change. That is, any method change made by the transferee will be applied prospectively to new long-term contracts entered into by the transferee.

d) Transferee Succeeds to Obligation under Deferred Revenue Contracts
Where the transferor has recognized and been taxed on deferred revenue that is reflected on the transferee's opening book balance sheet, the transferee must take care to avoid recognizing this income a second time for tax purposes. If the transferor pays or is deemed to pay the transferee to perform on contracts, that payment will be treated by the transferee as deferred revenue and will be taken into account under the accounting method the transferee adopts.

e) Transferee Succeeds to Supplies and/or Prepaid Expenses
The transferor may reflect supplies as an asset, because it keeps records of consumption or takes physical counts at the beginning and end of the year. If the transferee proposes to deduct supplies when purchased, it is unclear whether supplies that are transferred from the transferor may be deducted immediately under the transferee's new method of accounting or whether the transferee will deduct supplies on the opening balance sheet as they are consumed. Usually, when supplies turn quickly, either treatment provides a deduction in the first quarter of the year. Occasionally, if the transferor has a large inventory of supplies on hand on the date of transfer or the first year of the transferee is a short period, the treatment of supplies will become an issue. While the treatment is not clear, the better view is that the supplies on the opening balance sheet would be deducted as consumed rather than at the time of transfer.

The same issue arises in the case of prepaid expenses eligible for the 12-month rule under Reg. §1.263(a)-4(f). Again, while the treatment is not clear, in this author's view, the more appropriate treatment is to amortize the prepaid expenses on the opening balance sheet over the period benefited and then deduct new prepaid expenses as incurred.

C. Code §§381(c)(4) and (c)(5)
Code §381 provides rules for succeeding to taxable attributes, such as net operating loss carryovers, accounting methods, depreciation allowances, etc., in certain corporate reorganizations and tax-free liquidations. The following section discusses, among other things, the determination of accounting methods if a target corporation and acquiring corporation have the same or different accounting methods. Specifically, this discussion focuses on which method survives if accounting methods differ and, if there is a Code §481(a) adjustment, how that adjustment is taken into account (and by whom).

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95 See Reg. §1.460-1(h)(2), which generally provides that a change made to comply with Reg. §1.460-2-§1.460-5 is made on a cut-off basis.
96 Reg. §1.162-3.
97 This is the same result as discussed above with respect to the transfer of receivables from a cash basis transferor to an accrual basis transferee. The recognition of income is not accelerated as a result of the transfer. Instead, income is recognized as the transferee receives cash in excess of its basis in the transferred receivables. Here the transferee claims a deduction for the transferred basis in the supplies as the supplies are consumed and prospectively deducts supplies as purchased.
98 Reg. §1.263(a)-4(f) generally provides that an amount is not capitalized under Code §263(a) if the right or benefit created by such amount does not extend beyond the earlier of: (1) 12 months after the taxpayer first realizes the right or benefit; or (2) the end of the taxable year following the taxable year in which payment is made.
Treasury and the Service originally issued regulations under Code §§381(c)(4) and 381(c)(5) in 1964 and 1975, respectively. Proposed regulations were issued in 11/07. On August 1, 2011, Treasury and the Service issued new final regulations under Code §381(c)(4) and (c)(5). The final regulations generally adopt the provisions of the 2007 proposed regulations and are effective for Code §381(a) transactions occurring on or after August 31, 2011. The discussion that follows focuses on Code §381(a) transactions that are subject to the new regulations (i.e., those occurring on or after August 31, 2011) and summarizes some of the more significant provisions of Code §381 and the new regulations; however, it should not be a substitute for a careful reading of the Code and applicable regulations.

1. General Rules

Code §381 generally applies to a corporation's tax-free acquisition of another corporation's assets. In particular, Code §381 applies to reorganizations under Code §368 (except for reorganizations under §§368(a)(1)(B) or 368(a)(1)(E) and divisive reorganizations under Code §§368(a)(1)(D) and 368(a)(1)(G)) and to liquidations under Code §332. Thus, for example, a transaction in which a subsidiary corporation checks the box to be a disregarded entity under Reg. §301.7701-3, is a Code §332 liquidation and subject to the provisions of Code §§381(c)(4) and (c)(5).

Code §381 does not currently apply to contributions to corporations under Code §351 or to partnerships under Code §721. Consequently, subsidiaries and partnerships generally may avail themselves of a new method of accounting without first securing the consent of the Commissioner, because they do not succeed to the methods used by a corporate contributor. See the previous section for Code §351 considerations.

Following a nonrecognition acquisition to which Code §381 applies, an acquiring corporation must generally use the methods of accounting used by the target corporation. If, however, the trades or businesses of the acquiring corporation and the target corporation are integrated after the acquisition and the methods of accounting used in the respective trades or businesses differ, then the Code §381 regulations provide specific rules for determining the appropriate method or methods for the integrated business. If an acquiring corporation desires a method other than one required by Code §381, or if the method required by Code §381 is not a permissible method, the acquiring corporation must request permission to use a different method. The accounting method changes made under the rules of Code §381 are treated differently than those made under the administrative procedures set forth in Rev. Proc. 97-27 or Rev. Proc. 2011-14 (although many similarities exist). For example, the latter generally provide audit protection while method changes required by Code §381, generally offer no audit protection.

2. Determination of Method

If Code §381 applies to a transfer, the methods of accounting to be used by the acquiring corporation depend on two key factors: (1) whether the target corporation and the acquiring corporation used the same methods of accounting (overall methods, methods for specific items, or inventory methods); and (2) if different methods were used, whether the acquiring corporation will operate the acquired trades or businesses as separate and distinct trades or businesses.

99 REG-151884-03.
101 Code §381(a).
102 See, e.g., IRS Letter Ruling 9828018 (4/9/98).
103 But see Code §168(f)(7) (treating a transferee in a §351 or §721 transaction as the transferor, i.e., step-in-the-shoes treatment, for purposes of computing depreciation deductions); Reg. §1.1502-17 (requiring that the transferee, in a Code §351 transfer among members of an affiliated group that files consolidated returns, use the same methods of accounting used by the transferor if the principal purpose of the transaction was for the group to avail itself of a method that would not otherwise be available without the Commissioner's prior consent).
104 Code §§381(c)(4) and (c)(5).
105 2011 Reg. §1.381(c)(4)-1; 1.381(c)(5)-1.
a) Acquiring and Target Use the Same Accounting Methods

If all the parties to a Code §381(a) transaction used the same method of accounting on the date of distribution or transfer, irrespective of whether the trades or businesses of the parties are operated separately or integrated after such date, the acquiring corporation shall continue to use such method of accounting, unless the acquiring corporation has obtained the consent of the Commissioner to use a different method of accounting (note that under the 2011 final regulations, in the case of trades or businesses that will be integrated after the Code §381(a) transaction, voluntary method change requests will not be granted by the Service unless they are to the principal method the acquiring corporation must use after the transaction).

b) Acquiring and Target Use Different Accounting Methods

As discussed more fully below, if the acquiring and target corporations use different overall methods of accounting or different methods for any item, the acquiring corporation must generally continue to use the methods previously employed by the target corporation if the acquiring corporation operates the acquired trades or businesses as separate and distinct trades or businesses (i.e., methods carryover). On the other hand, if any trade or business of the target corporation is integrated or required to be integrated after the transaction with a trade or business of the acquiring corporation, the acquiring corporation must generally use the "principal" method or methods of accounting with respect to such integrated trade or business. Under the 2011 final regulations, if multiple trades or business are integrated, and more than one principal method (overall, special, or inventory method) exists, the acquiring corporation may choose which of such methods will be the principal method for the integrated business. However, the chosen method must be a permissible method of accounting.

(1) Separate and Distinct Trade or Business

As previously stated, if the acquiring corporation operates an acquired trade or business separately from its existing trades and businesses (i.e., without integrating the trades or businesses) after the transfer or distribution, then the acquiring corporation must continue to use the methods of accounting employed by the target corporation prior to the acquisition, unless acquiring corporation obtains the Commissioner's consent to change to a different method (i.e., methods generally carryover). As a practical matter, very few Code §381(a) transactions result in the immediate integration of operations and thus are operated separately for at least some period of time.

The 2011 final regulations provide that the time for determining whether there are separate trades or businesses is as of the date of the Code §381(a) transaction. However, the regulations, perhaps recognizing that immediate integration does not often occur, look to intent rather than actual integration. In this regard, the regulations provide a facts and circumstances test to determine whether the acquiring corporation will operate the acquired businesses separately or will integrate them with its existing business. For example, the 2011 final regulations provide that intent to combine books and records (such that the businesses are not separate under Reg. §1.446-1(d)) may be demonstrated by contemporaneous records and documents, or by other objective evidence, even though the actual combination of the books and records may extend beyond the end of the taxable year of the Code §381(a) transaction. However, the 2011 final regulations did not clarify what constitutes "other objective evidence", which is a common
area of confusion for many taxpayers, especially with regard to the treatment of disregarded entities. With respect to an integration of two trades or businesses that occurs after the end of the year that includes the transaction, the Service has indicated informally that any change to the methods of accounting of those trades or businesses requires prior consent that must be requested under the rules of either Rev. Proc. 97-27 or 2011-14, as appropriate.

The lack of clarity provides a taxpayer with some latitude in the application of this rule. For example, if an acquiring corporation desires to use a "principal" method of accounting as determined under Code §381, it can either (i) document its intent to integrate the trades or businesses on the date of the transaction, or (ii) take affirmative documented steps to begin integrating trades or businesses immediately after the transaction. On the other hand, if the continued use of non-principal methods is desired or if an accounting method change under Rev. Proc. 97-27 or 2011-14, which provide audit protection and other benefits, is desired, then the acquiring corporation might choose to delay any integration.

However, if a taxpayer may employ only a single method of accounting with respect to a particular item, regardless of the number of separate and distinct trades or businesses operated by the taxpayer, but different methods were employed by the target and acquiring corporations with respect to such item, then the acquiring corporation must use the "principal" method of accounting for such item (as discussed below) or request the Commissioner's consent to use a different method of accounting.\(^\text{114}\)

(2) Integrated Trade or Business

As previously stated, if the acquiring corporation immediately integrates target's operations into its existing business or evidences an intent, as of the date of the Code §381(a) transaction, to integrate the businesses, then a "principal" method analysis must be performed to determine the methods that are required to be used in the integrated trade or business. The determination of the principal method (which may require the taxpayer to change certain “non-principal” methods that were used in one or more of the trades or businesses that will be integrated), is discussed in more detail below. Generally, the principal method must be used by the acquiring corporation in the integrated trade or business unless such method is impermissible (in which case it must be changed with the Commissioner’s consent). Additionally, under the 2011 final regulations, any party to a Code §381(a) transaction may request permission under Code §446(e) to change a method of accounting for the taxable year in which the transaction occurs or is expected to occur provided the method is the principal method that the acquiring corporation must use after the date of the transaction.\(^\text{115}\)

3. Principal Method Determination

The determination of a principal method is made by reference to the methods of accounting used immediately before the date of the transaction by each of the component trades or businesses that now constitute an integrated trade or business of the acquiring corporation.\(^\text{116}\) Therefore, if more than one corporation merged at the same time or as part of the same plan, the different accounting methods used by all of the corporations with respect to an integrated trade or business are evaluated to determine the principal method of accounting. Under the 2011 final regulations, if there are multiple component trades or businesses with different principal methods (overall, special, or inventory method) the acquiring corporation may choose any of such methods to be the principal method for the integrated business, provided that such method is a permissible accounting method.\(^\text{117}\)

a) Principal Overall Method

\(^{114}\) 2011 Reg. §§1.381(c)(4)-1(a)(4), 1.381(c)(5)-1(a)(4)
\(^{115}\) 2011 Reg. §§1.381(c)(4)-1(a)(5), 1.381(c)(5)-1(a)(5).
\(^{116}\) 2011 Reg. §§1.381(c)(4)-1(c), 1.381(c)(5)-1(c).
\(^{117}\) 2011 Reg. §§1.381(c)(4)-1(c)(2), 1.381(c)(5)-1(c)(2).
Generally the principal overall method of accounting of an integrated trade or business is the acquiring corporation's method. However, the acquiring corporation's method will not be the principal method where either (i) the component trade or business of the distributor or transferor corporation is larger than the component trade or business of the acquiring corporation on the date of the transaction, or (ii) such method is not a permissible method. For purposes of Code §381(c)(4), the transferor corporation is larger if the aggregate adjusted bases of the assets held by the trade or business that will be integrated and the aggregate gross receipts for the 12 months preceding the date of the transaction (or shorter period during which a business was not in existence for the prior 12-month period) for that trade or business are greater than those of the acquiring corporation's trade or business that will be integrated. Note the significance of the "and" requirement in determining the larger corporation. If both tests are not met by the distributor/transferor corporation, the acquiring corporation's overall method, if permissible, is the principal method by default.

Additionally, under the 2011 final regulations, if multiple trades or business are integrated, and more than one principal method (overall, special, or inventory method) exists, the acquiring corporation may choose any of such methods to be the principal method for the integrated business, provided that the chosen method is a permissible method of accounting. As a practical matter, the 2011 final regulations did not define "multiple component trade or business" or describe in more detail than in Example 10 of Reg. 2011 Reg. §1.381(c)(4)-1(c)(3) what constitutes multiple component trades or businesses. As a result, the determination of what constitutes multiple component trades or businesses remains uncertain and may involve evaluating a variety of different factors.

As a practical matter, a principal method analysis of overall methods only applies if a cash-basis business and an accrual-basis business are integrated, because the Service generally recognizes only the cash method and the accrual method as proper overall methods of accounting. Because a cash-basis corporation typically will not have significant assets on its balance sheet (e.g., service businesses), it is difficult for the cash method to represent the principal method of accounting; i.e., the presence of significant accounts receivable and inventories on the balance sheet of an accrual-method corporation usually cause it to have greater total adjusted bases in its assets than a cash-basis corporation. Consequently, this comparison for determining a principal overall method of accounting generally results in a change to the accrual method, even in situations where a seemingly larger cash-basis corporation is merging with a seemingly much smaller accrual-basis corporation.

Under the 2011 final regulations, if a party to a Code §381(a) transaction has no, or is not using a, method of accounting, the party is treated as having the method of accounting of the other party to the Code §381(a) transaction.

b) Specific Item Principal Method

The 2011 final regulations provide that a principal method of accounting for an item for which a special method of accounting is available, other than for taking inventories, is determined using the same principles applied in the context of determining a principal overall method of accounting. If the larger component trade or business does not have a special method of accounting for a particular item immediately prior to the date of the Code §381(a) transaction, the principal method for that item is the method of accounting used by the component trade or business that does have a special method of accounting for that item.

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118 2011 Reg. §§1.381(c)(4)-1(c)(2), 1.381(c)(5)-1(c)(2).
119 2011 Reg. §1.381(c)(4)-1(c)(1).
120 2011 Reg. §1.381(c)(4)-1(c)(1).
121 2011 Reg. §1.381(c)(4)-1(c)(1).
Note if, the Code, regulations or other administrative guidance permit an acquiring corporation to elect a method of accounting on a project-by-project, job-by-job or other similar basis, the regulations allow methods to be established solely for that project or job. Generally, for ongoing projects or jobs, such method will continue after a Code §381(a) transaction. However, if businesses are integrated following a transaction and the parties to the Code §381(a) transaction previously worked on the same project or job and used different methods, then the principal item is determined in the same manner that the principal overall method is determined (i.e., the principal method of the acquiring corporation is used unless the target is larger or the principal method is impermissible).

c) Principal Inventory Method

The determination of the principal inventory method is made with respect to each particular type of inventory good of each integrated trade or business operated by the acquiring corporation immediately after the date of the transaction.

(1) Fair Market Value Comparison

Under the 2011 final regulations, for each integrated trade or business, the principal method for a particular type of inventory good is generally the inventory method used by the component trade or business of the acquiring corporation immediately prior to the date of the Code §381(a) transaction. However, if on the date of the Code §381(a) transaction, the component trade or business of the transferor corporation holds more inventory of a type of goods than the component trade or business of the acquiring corporation, then the principal method for such inventory goods is the inventory method used by the transferor corporation. As a simplifying measure, the 2011 final regulations allow the acquiring corporation to elect to measure the aggregate fair market values of all inventories held by each component trade or business of the acquiring and transferor corporations for purposes of determining the principal inventory method. If the component trade or business with the larger aggregate fair market value of the entire inventories does not have a method for a particular type of goods, the principal method for that type of goods is the method used by the component trade or business that does have an inventory method for that type of goods. In addition, if a party to a Code §381(a) transaction has multiple component trades or businesses and more than one principal inventory method for a particular type of goods, then the acquiring corporation may choose which of the methods is the principal methods, provided that the chosen method is a permissible method of accounting.

As a practical matter, unless two merged companies purchase or produce inventories that are a commodity, it would be unusual for two merging companies to produce goods that could not be assigned to different groups or pools because of different branding and different features or characteristics. Therefore, it would be unusual for Code §381 to mandate an inventory method change. However, once merged companies begin to produce a single branded item, the accounting for that single item must be the same.

(2) LIFO Method Election

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122 2011 Reg. §1.381(c)(4)-1(e)(9).
123 2011 Reg. §1.381(c)(4)-1(e)(9).
124 2011 Reg. §1.381(c)(5)-1(c)(1).
125 See Id.
126 See Id.
127 See Id.
128 2011 Reg. §1.381(c)(5)-1(c)(2).
For purposes of determining the principal method, the 2011 final regulations deem that a corporation uses the LIFO method of taking inventories on the date of the distribution or transfer, if such corporation elects under Code §472 the LIFO method for the tax year that includes the transaction.\(^{129}\)

(3) Special Inventory Combination Rules

The regulations under Code §381 provide special rules regarding the treatment of inventory combinations once the principal method of accounting for inventories has been determined.\(^{130}\) See section below discussing changes to use the principal method for additional details.

4. **Limitations on Use of Principal Method or Carryover Method**

An acquiring corporation cannot use the principal method of accounting (where trades or business are integrated) or carryover method of accounting (where taxpayer continues to operate separate and distinct trades or businesses) if such method is an impermissible method or otherwise fails to clearly reflect income. In this case, the acquiring corporation must request IRS consent to change to a permissible method. The acquiring corporation must generally follow the provisions of Reg. §1.446-1(e) and the applicable administrative procedures for voluntary changes in method of accounting under Code §446(e).\(^{132}\) Audit protection is provided in these circumstances. The method change rules in Rev. Procs. 97-27 (as modified, clarified and amplified) and 2011-14 apply in this case; thus the Service allows the four-year spread of any net positive Code §481 adjustment and a one-year pick-up of a net negative Code §481(a) adjustment. See below for additional details on how such changes are made.

5. **Option to Voluntarily Change the Principal Method or Carryover Method**

Any party to a Code §381(a) transaction may request permission under Code §446(e) to change a method of accounting for the taxable year in which the transaction occurs or is expected to occur. If either the acquiring corporation or target corporation makes a voluntary method change in the year a Code §381(a) transaction occurs or is expected to occur, then it must request consent from the Service to change its method of accounting to another method. In such cases, the provisions of Reg. §1.446-1(e) and the applicable administrative procedures for voluntary changes in method of accounting under Code §446(e) must be followed. Audit protection is provided in these circumstances. The method change rules in Rev. Procs. 97-27 (as modified, clarified and amplified) and 2011-14 apply in this case; thus the Service allows the four-year spread of any net positive Code §481 adjustment and a one-year pick-up of a net negative Code §481(a) adjustment. See below for additional details on how such changes are made.

Also, for trades or businesses that will be integrated after the Code §381(a) transaction, a change in method of accounting for the taxable year that includes the date of the Code §381(a) transaction will be granted only if the requested method is the method that the acquiring corporation must use after the date of the transaction (i.e., the principal method).\(^{137}\)

6. **Code §381 Method Change Rules**

a) Change to Permissible Principal Method

\(^{129}\) 2011 Reg. §1.381(c)(5)-1(c)(5).
\(^{130}\) 2011 Reg. §1.381(c)(5)-1(e).
\(^{131}\) 2011 Reg. §§§1.381(c)(4)-1(a)(3), 1.381(c)(5)-1(a)(3), 1.381(c)(4)-1(a)(10), 1.381(c)(5)-1(e)(10), 1.381(c)(4)-1(a)(12), 1.381(c)(5)-1(e)(12).
\(^{132}\) 2011 Reg. §§§1.381(c)(4)-1(a)(2)(i), 1.381(c)(5)-1(d)(2)(i).
\(^{134}\) 2011 Reg. §§§1.381(c)(4)-1(a)(10), 1.381(c)(5)-1(a)(10), 1.381(c)(4)-1(a)(2)(i), 1.381(c)(5)-1(d)(2)(i).
\(^{136}\) 2011 Reg. §§§1.381(c)(4)-1(a)(5), 1.381(c)(5)-1(a)(5).
Under the 2011 final regulations, a taxpayer makes a change to a required principal method of accounting under Code §381 without seeking the consent of the Commissioner. The acquiring corporation takes into account the appropriate amount of any increase or decrease in tax resulting from such change on its federal income tax return for the taxable year that includes the date of the Code §381(a) transaction. To the extent the use of a principal method constitutes a change in method of accounting, the change in method is treated as a change initiated by the acquiring corporation for purposes of Code §481(a)(2). The amount of the Code §481(a) adjustment and the adjustment period, if any, necessary to implement a change to the principal method are determined under Reg. §1.446-1(e) and the applicable administrative procedures that govern voluntary changes in methods of accounting under Code §446(e). If under Code §446(e) and the regulations thereunder, a method of accounting is required to be implemented on a cut-off basis, the acquiring corporation must implement the change on a cut-off basis as of the date of distribution or transfer on its federal income tax return for the taxable year that includes the date of the Code §381(a) transaction.

If, however, Code §446(e) and the regulations thereunder require a Code §481(a) adjustment, the acquiring corporation must determine the Code §481(a) adjustment and include the appropriate amount of the adjustment on its federal income tax return for the taxable year that includes the date of the Code §381(a) transaction and subsequent taxable year(s), as necessary. Thus, if a negative Code §481(a) adjustment results acquiring includes the entire adjustment on its return for the taxable year that includes the date of the Code §381(a) transaction. If instead a positive Code §481(a) adjustment results acquiring would include one-fourth of the adjustment in its return for the taxable year that includes the date of the Code §381(a) transaction and the remainder ratably over the next three years. The adjustment is determined by the acquiring corporation as of the beginning of the day that is immediately after the date of the Code §381(a) transaction.

b) Special Inventory Combination Rules

The regulations under Code §381 provide special rules regarding the treatment of inventory combinations (i.e., inventory method changes) once the principal method of accounting for inventories has been determined.

(1) Combining Dollar-Value and Specific Goods LIFO Methods

If an acquiring corporation is required to use or is permitted to continue using a dollar-value LIFO method and a transferor corporation used a specific-goods LIFO method, the inventories of the transferor corporation are changed to the dollar-value LIFO method, in accordance with Reg. §1.472-8(f), and the inventories of the corporations are integrated. In essence, the transferor corporation's specific-goods LIFO inventories will be grouped using the acquirer's pooling system (as if target had always used acquiring corporation's dollar-value LIFO pooling system) and then will be integrated into acquiring corporation's LIFO pools.

If an acquiring corporation is required or permitted to combine inventories pools, acquiring and transferor corporation's pools are combined in accordance with the principles set out in Reg. §1.472-8(g)(2),

138 2011 Reg. §§1.381(c)(4)-1(c)(1), 1.381(c)(5)-1(e)(1).
139 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
140 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
141 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
142 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
143 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
144 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
145 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
146 2011 Reg. §§1.381(c)(4)-1(d)(1), 1.381(c)(5)-1(d)(1).
147 2011 Reg. §§1.381(c)(5)-1(e).
148 See Id. See also 2011 Reg. §§1.381(c)(5)-1(e)(6)
149 See Id. See also 2011 Reg. §§1.381(c)(5)-1(e)(6)
which require that combined pools utilize a common base-year—the earliest base year in the case that acquiring and transferor corporation's inventory pools have different base years. In combining pools, all base-year inventories and increment layers occurring in taxable years that include the same 12/31 year end are combined. 150 A base-year inventory or increment layer occurring in any short taxable year that does not include 12/31 or in the final taxable year of a target corporation are merged with and considered a year end increment layer for the immediately preceding taxable year. 151

(2) Target Corporation Does Not Use LIFO

If an acquiring corporation is required to use or is permitted to continue using a LIFO method and a target corporation did not use a LIFO method prior to the date of the transfer or distribution, then the acquiring corporation is treated as having acquired the inventory of the target corporation at its average unit cost in a single transaction on such date. 152 Adjustments for a restoration to cost of any prior deduction accrued by the target corporation to write such inventories down to market value is taken into account by such corporation ratably in each of the three taxable years beginning with the taxable year that includes the date of the distribution or transfer.

If the principal method of accounting for inventories is a LIFO method and the non-principal method is FIFO, lower of cost or market (LCM) method, it is possible that the restoration to cost of prior FIFO LCM adjustments creates a significant drawback to using LIFO as the principal method. In such a case, parties to a Code §381 transaction might consider filing a change in method of accounting for the year including the Code §381 transaction such that LIFO is terminated and FIFO LCM becomes the principal method of accounting. Such a change would enable the parties to avoid a restoration of prior market writedowns, but at a cost of terminating LIFO for a majority of the inventories in the transaction. On the other hand, a method change to elect LIFO for FIFO LCM inventories for the year of the Code §381 transaction may provide a four-year spread of any unfavorable writedown-restoration adjustment.

(3) Change to Specific Goods LIFO

If an acquiring corporation is required to use or is permitted to continue using a specific goods LIFO method, then the acquiring corporation is treated as having acquired the inventories of each transferor corporation that used such LIFO method on the same acquisition dates and at the same costs as the target corporation. 153 However, if a target corporation did not use such LIFO method, the acquiring corporation is treated as having acquired the inventories of the transferor corporation at its average unit cost in a single transaction on the date of the distribution or transfer. 154

(4) Acquiring Corporation Uses FIFO

If an acquiring corporation is required to use or is permitted to continue using a FIFO method, then the inventories of each target corporation that does not use the FIFO method is treated by the acquiring corporation as having the same acquisition dates and costs that such inventory would have had if the target corporation had been using the FIFO method for its taxable year in which the transaction occurred. 155 If the acquiring corporation values its inventories using a lower-of-cost-or-market method, then the acquiring corporation treats the acquired inventories as having been acquired at the lower of their cost or market values. 156

(5) Acquiring Corporation and Target Corporation Use FIFO

150 See Id. See also 2011 Reg. §§1.381(c)(5)-1(e)(6)
151 See Id. See also 2011 Reg. §§1.381(c)(5)-1(e)(6)
152 See Id. See also 2011 Reg. §§1.381(c)(5)-1(e)(6).
153 See Id. See also 2011 Reg. §1.381(c)(5)-1(e)(6).
154 See Id. See also 2011 Reg. §1.381(c)(5)-1(e)(6).
155 See Id. See also 2011 Reg. §1.381(c)(5)-1(e)(6).
156 See Id. See also 2011 Reg. §1.381(c)(5)-1(e)(6).
If an acquiring corporation is required to use or is permitted to continue using a FIFO method, then the inventories of each transferor corporation that used such FIFO method is treated by the acquiring corporation as having the same acquisition dates and costs as the target corporations.\(^{157}\) If the acquiring corporation values its inventories using a lower-of-cost-or-market method, then the acquiring corporation treats the acquired inventories as having been acquired at the lower of their cost or market values.\(^{158}\)

6. No Cut-Off Method Change Permitted

Generally, if a taxpayer using a LIFO method voluntarily changes to another LIFO method (e.g., double extension to the use of an external index), such a change is made without a Code §481(a) adjustment and the taxpayer's LIFO reserve remains unchanged. If taxpayer contemplates reorganization and expects a change within a LIFO inventory accounting method under Code §381, the taxpayer will generally make that change with a Code §481(a) adjustment. This difference in treatment may cause a change under Code §381 to be more favorable (e.g., where a net negative §481(a) adjustment results) or to be less favorable (e.g., where a net positive §481(a) adjustment results). Therefore, prior to a Code §381 transaction, a taxpayer should evaluate the LIFO methods used by the parties to the transaction and compare the effect of a method change under Code §381 with a change under Rev. Proc. 97-27 or Rev. Proc. 2011-14.

Corporations involved in a Code §381(a) transaction should consider the use of accounting method changes to avoid having to use an unfavorable principal method (e.g., electing LIFO to ensure that LIFO will be the principal method among the combined inventories), to obtain a four-year spread of unfavorable adjustments that result from inventory combinations (e.g., spreading LIFO recapture resulting from an inventory combination in which FIFO is the predominant method), or to avoid other potentially unfavorable results of the inventory combination rules outlined above.

c) Effect of Prior Elections

In any case where a principal method of accounting is continued, it is unnecessary for the acquiring corporation to renew any election previously made by it or by a target corporation with respect to such principal method.\(^{159}\) The acquiring corporation, however, is also bound by any election previously made by it or by any target corporation with respect to such method of accounting that was in effect on the date of the transaction to the same extent as though the distribution or transfer had not occurred.\(^{160}\)

For example, if the principal method of accounting for inventory is LIFO and the acquiring company (as a result of the transaction) must change its FIFO inventory method to the LIFO method, the acquiring corporation is not required to file a Form 970 in the first return following a merger. The acquiring corporation is bound, just as the target corporation was prior to the merger, by the LIFO election.

7. Time and Manner of Making Application to Change to Different Method

The 2011 final regulations prescribe filing rules for applications requesting consent to change to an appropriate method of accounting when a principal method of accounting (where trades or businesses are integrated) or carryover method of accounting (where separate and distinct trades or business are maintained) is impermissible or otherwise fails to clearly reflect income, and for applications requesting consent to voluntarily change to a permissible principal method (where trades or business are integrated) or to a permissible method that will carryover (where separate and distinct trades or businesses are maintained).\(^{161}\) Such applications (i.e., Form 3115) should be labeled "Filed under Code §381(c)(4) or Code §381(c)(5)" as applicable, at the top.\(^{162}\) To the extent the accounting method change falls within

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\(^{157}\) See Id. See also 2011 Reg. §1.381(c)(5)-1(e)(6).

\(^{158}\) 2011 Reg. §1.381(c)(5)-1(e)(6).

\(^{159}\) 2011 Reg. §§ 1.381(c)(4)-1(e)(2) and (3), 1.381(c)(5)-1(e)(3) and (4).

\(^{160}\) See Id.

\(^{161}\) 2011 Reg. §§1.381(c)(4)-1(d)(2), 1.381(c)(5)-1(d)(2).

\(^{162}\) 2011 Reg. §§1.381(c)(4)-1(d)(2), 1.381(c)(5)-1(d)(2).
the scope of the automatic consent procedures (see Rev. Proc. 2011-14, as modified, clarified and amplified), the Form 3115 must be filed on or before the date that the return for the taxable year in which the distribution or transfer occurred is filed (or earlier if the return is filed after the due date, plus applicable extensions). However, to the extent the accounting method change requires advanced consent, the Form 3115 must be filed on or before the later of—

- The due date for filing a Form 3115 as specified in Reg. §1.446-1(e) (i.e., the last day of the taxable year in which the distribution or transfer occurred); or
- The earlier of—(i) the day that is 180 days after the date of the Code §381(a) transaction or (ii) the day on which the acquiring corporation files its federal income tax return for the taxable year in which the distribution or transfer occurred.\(^{163}\)

8. **Character of Items of Income and Deduction**

Section 1.381(c)(4)-1(e)(8) of the 2011 final regulations provides that after the date of distribution or transfer, items of income and deduction have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation if no distribution or transfer had occurred.

It is unclear to what extent, if any, this language addresses the ordinary or capital character of an asset. Nor is it clear what impact it has on a line of judicial and administrative guidance which held that asset character is not succeeded to by the acquiring corporation.\(^{164}\) Given this line of judicial and administrative guidance, it may be reasonable to conclude that the reference to "items of income and deduction" does not extend to the ordinary or capital character of an asset.

D. **Due Diligence**

In any situation in which an acquiring company acquires stock and accounting methods will, as a consequence, carry over to the acquiring company, a review of existing methods of accounting, the accounting for particularly large transactions, prior changes in method of accounting (with or without permission), accounting issues raised during IRS examinations, and any closing agreements entered into with the Service as a result of an examination are critical aspects of due diligence. This review starts with a copy of a detailed trial balance, the tax return, detail of the Schedule M-1/M-3 adjustments, and the audited financial statements (complete with footnotes). If the target is in a regulated industry or files reports with a federal agency, e.g., utilities, insurance companies, hospitals, these reports may also provide meaningful information. In addition, the Service may have an open Industry Audit Guide that may offer insight into issues that are unique to target's particular industry.

In addition to exposure items, due diligence may reveal opportunities for the target to utilize more favorable methods of accounting. An astute seller will review its methods of accounting before the sale so that it can make strategic decisions as to whether the selling price for target is maximized through requesting favorable method changes before the sale or after the sale. Sometimes the timing of a favorable method change may become an item of negotiation between seller and acquiring.

As a practical matter, many of the exposure items that are erroneous accounting methods can be corrected through an accounting method change (generally via a Form 3115 filing) that provides audit protection

\(^{163}\) 2011 Reg. §§1.381(c)(4)-1(d)(2)(iii), 1.381(c)(5)-1(d)(2)(iii).

for prior years, which can mitigate audit exposure for pre-acquisition years. In some cases it is not possible to obtain audit protection for prior years through an accounting method change request. Where it is not possible to obtain audit protection for prior years through a method change, acquiring will frequently require the seller to establish an escrow (or a holdback) to cover the contingent tax liability.

E. Planning Around Taxable Years

Restructuring presents a number of opportunities and pitfalls that derive from the rules surrounding taxable years. As a general matter, the taxable year of a C corporation will continue following an acquisition as long as the corporation files a separate return. If, however, the C corporation leaves a consolidated group and/or enters a new consolidated group, the rules in Reg. §1.1502-76(b)(1)(ii) provide that the taxable year ends at the end of the day the corporation leaves the old group or enters the new group. Reg. §1.1502-76(a)(1) also provides that new members entering a consolidated group immediately change to the taxable year of the common parent. In addition, transactions that terminate the corporation (e.g., liquidation, merger) obviously end the corporation's taxable year and, where applicable, the taxable year of the entity that survives the transaction continues. The following are some common situations in which taxable years become an issue:

1. Short Periods Affect the Ability to Defer Income Recognition from Advance Payments under Either Rev. Proc. 2004-34 or Reg. §1.451-5

Rev. Proc. 2004-34 requires qualifying deferred revenue be taken into income no later than the taxable year following the year of receipt. Similarly, Reg. §1.451-5 requires qualifying deferred revenue from the sale of goods be taken into income no later than the second taxable year following the year of receipt. The short periods that are created as a result of restructuring are treated as separate taxable years for all purposes of the Code. Consequently, a series of two or more short periods can cause an acceleration of income that is not anticipated by the parties to the transaction. Under Rev. Proc. 2004-34, however, a short period of 92 days or less will be disregarded as a separate taxable year for this purpose.

One way to plan around the short year problem is to close the transaction on the last day of the taxable year to avoid a short period. Another possible alternative is to structure the sale as an asset sale and allow the selling company to remain obligated on the contracts generating the deferred revenue. The selling company could then subcontract its obligation to the purchasing party.

2. Short Periods Affect the Ability to Deduct Deferred Compensation

Deferred compensation (i.e., compensation for which services are provided in one taxable year, but that is paid in the next taxable year) is deductible if accrued during the taxable year and paid within 2½ months following year end. As a consequence, for example, the profit on which a bonus is based may be earned during the first short-period but, because the liability to pay the bonus does not become fixed until year-end or because the bonus is paid more than 2½ months after the end of the first short-period, the compensation may not be deductible until the second short period or even until the following 12-month taxable year. If the company with the liability for the compensation liquidates before claiming the

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165 See, e.g., Code §381(b)(1).
166 2004-1 C.B. 991.
167 See Section 4.01(3) of Rev. Proc. 2004-34 for types of advanced payments qualifying for deferral.
169 Reg. §1.451-5(b).
170 Code §441(b)(3).
171 Section 5.02(2) of Rev. Proc. 2004-34 includes a special rule that generally allows a taxpayer to continue to defer an advance payment if it would otherwise be triggered in a short period of 92 days or less.
172 Code §404(b) and Reg. §1.404(b)-1T, Q&A-2.
deduction and the bonus is not paid within 2½ months of the liquidation (i.e., year-end), it is possible the deduction will be lost.\textsuperscript{173}

3. \textit{Short Periods Affect the Ability to Deduct Expenses under the Recurring Item Exception Election}

The recurring item exception of Code §461(b)(3) allows a taxpayer to accrue qualifying expenses that meet the all events test of Code §461 at year-end and for which economic performance occurs at the earlier of (1) the date on which the federal income tax return for the year of accrual is filed, or (2) within 8½ months following the end of the year of accrual. The recurring item exception generally allows taxpayers to accrue qualifying payment liabilities such as state income taxes, personal and real property taxes, and insurance premiums in the taxable year prior to the year of payment, provided payment is made within 8½ months of the end of such tax year. Absent short periods, a taxpayer would typically analyze its eligible accrual to determine what portion of the accrual was paid within 8½ months following the typical year end (and not necessarily 8 ½ months after the short year end).

Planning around the recurring item exception election often focuses on accelerating or delaying payments where possible.

4. \textit{Short Periods Affect the 12-Month Rule under Reg. §1.263(a)-4(f)}

Under Reg. §1.263(a)-4(f), an amount paid to create an intangible asset is not required to be capitalized if the right or benefit created by such amount does not extend beyond the earlier of (1) 12 months after the taxpayer first realizes the right or benefit; or (2) the end of the taxable year following the taxable year in which payment is made. Although this rule is often referred to as a 12-month rule, short taxable years may cause amounts that would otherwise be deductible to be capitalized.

5. \textit{Structure of a Transaction Causes the Less Desirable Taxable Year to Survive}

The taxable year that survives a transaction varies depending on the form. In a merger, the year of the legal survivor survives. If the smaller of two corporations survives because it is incorporated in a favorable jurisdiction but the desired tax year is that of the larger of the two corporations, problems can result. Also, the consolidated return regulations provide that all members must change to the taxable year of the common parent of the group unless the transaction is a reverse acquisition.\textsuperscript{174} In the case of a reverse acquisition, the year of a deemed parent survives. In some cases, tax year issues are not discovered until long after the transaction has closed when the tax department prepares the first tax return and discovers that the book year is different from the proper tax year.

It may be possible to avoid the problem altogether by simply anticipating the problem and requesting permission to change the tax year of the company with the surviving taxable year before the transaction. If this is not possible, taxpayers may request permission to change to another taxable year after the transaction.

6. \textit{Change in Taxable Year before the Transaction}

Occasionally it is desirable to change a taxable year before a transaction to isolate pre-transaction earnings and profits. Assume for example a foreign corporation with substantial earnings and profits through 9/30/08 is acquired by a domestic corporation on 10/1/08, and becomes a controlled foreign corporation. If the foreign corporation were to change its year-end to September in advance of the

\textsuperscript{173} See, e.g., IRS TAM 8939002 (6/9/89), holding that where target (T) liquidated immediately following the acquisition, T was not entitled to deduct non-qualified deferred compensation accruals assumed by P on its final return.

\textsuperscript{174} Reg. §1.1502-76(a)(1).
transaction,\textsuperscript{175} the domestic corporation may be able to avoid reporting earnings and profits accrued prior to the acquisition.\textsuperscript{176}

7. \textit{Short Periods Accelerate the Amortization of Code §481(a) Adjustments}

Parties to the restructuring may have previously changed accounting methods and have unamortized Code §481(a) adjustments.\textsuperscript{177} The short period that is created as a result of a transaction is considered a taxable year for all purposes of the Code, including the amortization of Code §481(a) adjustments.\textsuperscript{178} As a consequence, if the adjustment is amortized over four years, more than 1/4 of the adjustment may be included in the 12-month period that includes the transaction.

II. \textbf{Contingent Liabilities}

In discussing this area, it should be noted at the outset that there is no precise definition of the term "contingent liability." The plain meaning of the term suggests that it is an item for which the fact of liability has not been established, such as in the case of pending legal action. Buyers and sellers generally encounter two types of contingent liabilities: (1) known contingent liabilities and (2) unknown contingent liabilities.

As discussed below, in the context of actual asset sales, the §1060 regulations do not provide guidance with respect to what is a contingent liability or how such a liability should be treated for tax purposes. Accordingly, in such a case, general tax principles apply. Similarly, in the case of deemed asset sales under Internal Revenue Code (IRC or Code) §338 (where certain stock acquisitions are treated as asset acquisitions), the regulations issued in 2001 clarify that contingent liabilities under Code §338 should be treated under general tax principles in the same manner as contingent liabilities under Code §1060.\textsuperscript{179} By contrast, the prior regulations defined a contingent liability as one that is not fixed and determinable and also provided rules for how such a liability is treated for tax purposes.

Liabilities in general—both fixed and contingent—are normally assumed by the purchaser in a taxable asset acquisition or a Code §338 deemed asset acquisition. Such liabilities are also typically assumed by the transferee in a Code §351 transfer, as well as a tax-free reorganization under Code §368. Liabilities may also be assumed in bankruptcy proceedings.\textsuperscript{180} While the treatment of fixed liabilities is relatively straightforward in such transactions, the treatment of contingent liabilities is more problematic. Contingent liabilities typically assumed in these transactions are environmental, tort, deferred compensation, and retiree medical liabilities.

\textbf{EXAMPLE}

Assume Buyer acquires the assets of Seller, which constitute a trade or business under Code §1060(c), by paying $600 in cash and assuming liabilities related to the business of $700. If the liabilities assumed have already met all of the requirements for deduction by

\textsuperscript{175} See Prop. Reg. §§1.898-1 through 1.898-4 for rules relating to the taxable year of controlled foreign corporations (CFCs).

\textsuperscript{176} See also §4.02(8) of Rev. Proc. 2006-45, the automatic procedure for changes in annual accounting period for corporations.

\textsuperscript{177} In proposed regulations issued under Code §312, the IRS has clarified that if property is transferred after an acquisitive asset reorganization and no gain or loss is recognized, no allocation of the earnings and profits of the transferor is made to the transferee unless the transfer is described in Code §381(a). See REG-141268-11, 77 Fed. Reg. 22515 (Apr. 16, 2012).

\textsuperscript{178} Both §5.02(3)(a) of Rev. Proc. 97-27, 1997-1 C.B. 680 and §5.04(1) of Rev. Proc. 2011-14, 2011-4 I.R.B. 330, provide that the §481(a) adjustment is four taxable years for a net positive adjustment for an accounting method change and one taxable year for a net negative adjustment for an accounting method change.


\textsuperscript{180} See T.D. 8940 (2/12/01).

\textsuperscript{180} In IRS CCA 201036009, the IRS declined to rule that the mere fact that the liabilities were assumed in bankruptcy precluded such liabilities from being required to be capitalized under Code §263, instead applying a facts and circumstances analysis (5/25/2010).
the Seller as of the acquisition date, Seller has proceeds of $1,300 from the sale and Buyer
takes $1,300 basis in the assets purchased. This result is relatively clear because the
liabilities are fixed.181

The result is less clear, however, if $400 of the $700 liabilities consists of a contingent
liability—e.g., a book accrual for an estimated settlement of a pending lawsuit. Should the
$400 contingent liability be included as consideration on the date of acquisition (i.e.,
included in the Buyer's basis in the assets and the seller's amount realized)? What are the
consequences if the lawsuit is settled for more or less than the estimate—can the Buyer
deduct the excess or must it capitalize that amount? In a somewhat related vein, what if the
liability is fixed and determinable, but economic performance has not occurred? The
answers to these questions directly impact the negotiation of purchase price.

A. **Is the Liability Assumed?**

The threshold question that must be answered is whether a contingent liability has been assumed by the
buyer or, instead, arose after the transaction. This question is answered by an analysis of the facts of each
transaction and the courts and the Internal Revenue Service (IRS or the Service) have focused on a variety
of factors in making these determinations. In determining if the liability has been assumed, the courts and
the IRS will look to the following factors:

1. **Effect of Post-Acquisition Events**

If a contingent liability is not, in fact, a liability of the seller at the time of the transaction but arises
afterwards, the buyer would be entitled to a deduction once the requirements for deductibility are met. In
*Albany Car Wheel Company, Inc. v. Commissioner*,182 the Tax Court held that the buyer could deduct its
payment of severance wages under a union agreement. The buyer had replaced the agreement existing at
the time of the acquisition with a new pact it negotiated with the union.183

This factor frequently arises in cases determining the deductibility of employee death benefits. In general,
the resolution of these cases turns on when the death occurred. Payments on the account of a post-
acquisition death generally are deductible by the buyer. Where the employee died before the acquisition,
courts have held that the buyer's subsequent liability payments had to be added to the buyer's basis rather
than deducted.184

Moreover, this factor is also extremely significant in cases involving environmental contamination. In
general, the courts and the IRS have held that if the taxpayer acquires the property in an uncontaminated
state and subsequently contaminates it, remediation costs are deductible.185 In contrast, if the taxpayer
acquires the property in a contaminated state, any remediation costs must be capitalized.186 The fact that
the taxpayer was unaware of the contamination at the time of the acquisition does not appear to affect this
analysis, at least from the standpoint of the IRS. For example, in IRS Letter Ruling 200108029,187 the
taxpayer purchased property that contained a dry cleaning business. The fact that the property was
contaminated was unknown to the taxpayer at the time of the acquisition. The taxpayer incurred costs to

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181 See Reg. §1.1001-2(a).
182 40 T.C. 831 (1963), aff'd, 333 F.2d 653 (2d Cir. 1964).
183 The buyer negotiated the new union agreement contemporaneously with the purchase agreement and, in fact, was signed
several days before the purchase agreement was signed.
184 See, e.g., M. Buten & Sons, Inc. v. Commissioner, T.C. Memo 1972-44 (payments on account of post- but not
preacquisition deaths were deductible); David R. Webb Co, Inc. v. Commissioner, 77 T.C. 1134 (1981) aff'd, 708 F.2d 1254 (7th Cir. 1983)
(buyer's payments of benefits on account of employee's preacquisition death were not ordinary and
necessary expenses but were capital in nature).
185 See, e.g., Rev. Rul. 94-38; IRS Letter Ruling 199952075.
187 (11/24/00).
clean up the soil and groundwater contamination, which it deducted. The IRS held that the clean-up costs had to be capitalized, because the taxpayer acquired the property in a contaminated state, notwithstanding that the taxpayer was unaware of the contamination.

One issue that often arises is whether a buyer can deduct a portion of the contingent liability in situations where the liability greatly exceeds the amount that was anticipated by the buyer and seller. In this situation, taxpayers argue that the excess contingent liability constitutes a post-acquisition event that was not anticipated by the parties. This issue was addressed in Illinois Tool Works v. United States, where the taxpayer acquired a business and agreed to assume liability for certain patent infringement lawsuits that were pending against the seller. As part of its due diligence review of the acquired business, the taxpayer ascribed a 98 to 99% chance of prevailing at trial, with a worst-case scenario exposure of $1 million to $3 million. The pending patent infringement lawsuit did not affect the negotiation of purchase price. The reserve for the lawsuit, in the course of the acquisition, was eventually set at $350,000. At the conclusion of the due diligence review, the purchase price of the acquired assets was adjusted from $126.5 million to $125.5 million. The taxpayer and the seller considered the pending lawsuit, but the lawsuit liability did not affect the adjustment in the purchase price. The acquisition closed on 4/24/90. On 1/17/91, the jury returned a verdict in favor of the plaintiff in the amount of $4,647,905 for patent infringement and $6,295,167 in prejudgment interest. The district court doubled the patent infringement award because the jury found that the infringement had been willful, resulting in a verdict totaling $15,590,977. After the appeals had been exhausted, the taxpayer paid a total of $17,067,339, which included accumulated interest. The taxpayer capitalized $1 million as a cost of acquiring the business and deducted the remaining $16 million. The Seventh Circuit held that the entire amount had to be capitalized as part of the purchase price, stating that the fact "that a contingent liability, once fixed, exceeded the parties expectations does not render it any less a part of the purchase price." IRS Letter Ruling 200730014 also illustrates the impact of post-acquisition events. In that ruling, the IRS concluded that a contract termination fee was not required to be capitalized by the acquirer, because the terminated contract was not an assumed liability. In a taxable asset acquisition, the acquirer assumed certain of the target's executory contracts for the supply of natural gas. Years later, the contract became unfavorable, because the market price of gas exceeded that provided in the agreement. The acquirer paid a fee to the other party to terminate the contract and then entered into a new agreement with that party with a more favorable pricing term. The IRS concluded that the original contract was not an assumed liability; thus, the termination fee was not required to be capitalized as a cost of the assets acquired. The IRS concluded that the original contract was not an assumed liability, first because it was an executory contract, and also because the contract was not factored into the purchase price of the target's assets. Lastly, the IRS concluded that the termination fee was not a cost of the assets acquired, because the conditions that made the contract unfavorable arose during the time the contract was held by the taxpayer. The unfavorable conditions did not exist at the time the taxpayer acquired the contract.

188 355 F.3d 997 (7th Cir. 2004) aff'g, 117 T.C. 39 (2001). See also Pacific Transport Co. v. Commissioner, 483 F.2d 209, 213 (9th Cir. 1973) (noting that a taxpayer's failure to realize the substance or amount of a contingent liability assumed when acquiring property does not change its tax treatment—the payment must be capitalized). Despite these cases, it still might be possible to argue that if the costs of a contingent liability exceed the amount anticipated by the parties, it is deductible. The Tax Court in Pacific Transport held that the portion of a contingent liability in excess of insurance was so speculative and remote that the parties could not have intended it to factor into the purchase price. T.C. Memo 1970-41.

189 See also Merkel v. Commissioner, 109 T.C. 463 (1997) (holding that, for purposes of the insolvency exception under Code §108, contingent liabilities will be treated as liabilities if it is more probable than not that the taxpayer will be called upon to pay that obligation in the amount claimed).

190 355 F.3d at 1003.

191 (7/30/07).

See and compare Veco Corp. v. Comm'r, 141 T.C. No. 14 (2013) (where the court stated that the terms of the agreements are relevant in deciding when liabilities become fixed under the all events test - suggesting that, depending on the language in the contract, the execution of a contract may in fact fix the liability in certain circumstances)
2. **Financial Statements**

Financial statement accruals are a significant indicator of the existence of a liability.\(^{192}\) Liabilities recorded on the seller's financial statements, however, should be distinguished from those entered on the buyer's records. The buyer generally sets up a reserve account and accures and capitalizes as many anticipated costs as possible on the acquisition. Subsequent payments of those costs are offset against the reserve, rather than charged to current income. Reserves may be created for store or plant closings, severance payments, or other expenses associated with a downsizing. It may appear that these items should be added to basis, because they relate to conditions existing at the time of acquisition. Nevertheless, they are liabilities that should be fully deductible by the purchaser as the expenses are incurred (subject, of course, to the general rules for deductibility), because the decision to incur the expense is solely at the purchaser's discretion. A liability that exists prior to the acquisition is generally reflected on the seller's financial statements.

3. **Expressly Assumed**

Another factor taken into account in determining whether a liability has been assumed is whether, under the terms of the contract between the buyer and seller, the buyer expressly assumed the contingent liability.\(^{193}\) The fact that a contingent liability was expressly assumed would seem to preclude any argument that it was not intended to be part of the purchase price. Nevertheless, courts and the IRS have found a contingent liability was not an assumed obligation of the seller, despite contractual language to that effect. For example, in *Albany Car Wheel Company, Inc. v. Commissioner*,\(^{194}\) the buyer expressly assumed the seller's liability to make severance payments to its union employees. Despite this contractual language, the court found that the buyer's obligation to make severance payments arose out of a post-acquisition event—the buyer's negotiation of a new union contract—and not the assumption of the seller's obligation.

Similarly, in Gen. Couns. Mem. 39274,\(^{195}\) the buyer expressly assumed an obligation for Code §412 minimum funding and any past-service liabilities. Past-service liabilities are those obligations that the plan might assume, such as an additional funding obligation, due to an increase in the retirement benefit payable under the plan. The IRS held that the Code §412 minimum funding obligations that arise in post-acquisition plan years and the payment of past service liabilities are deductible. The IRS concluded that the buyer does not have a contractual liability to continue making minimum funding liability payments or past-service liability payments, because the buyer's choice whether or not to maintain such a plan was discretionary and constituted the buyer's own ordinary and necessary business expense.

4. **Reflected in Purchase Price**

Whether or not the liability was reflected in the purchase price is also a factor that is taken into account in determining whether the liability was assumed by the buyer. In general, this is evidenced by a reduction in the purchase price.\(^{196}\) However, in *Illinois Tool Works*, the fact that the parties considered the existence of a contingent liability in determining purchase price, even though the liability did not ultimately affect the amount of the purchase price, was found to be evidence that the liability was assumed. It was specifically noted in the facts that the purchase price was reduced as a result of due diligence findings, but

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\(^{192}\) See, e.g., IRS TAM 8741001 (6/16/87).

\(^{193}\) See, e.g., Illinois Tool Works v. Commissioner, 355 F.3d 997 (7th Cir. 2004) aff’g, 117 T.C. 39 (2001); David R. Webb v. Commissioner, 708 F.2d 1254 (7th Cir. 1983) aff’g 77 T.C. 1134 (1981). Note also that the exception for economic performance for liabilities assumed in connection with the sale of a trade or business provides that such liabilities must be "expressly assumed."

\(^{194}\) 40 T.C. 831 (1963), aff’d, 333 F.2d 653 (2d Cir. 1964). See also IRS Letter Ruling 8411106 (12/16/83); IRS Letter Ruling 8623033 (3/11/86).

\(^{195}\) (8/16/84).

\(^{196}\) See United States v. Minneapolis & St. Louis Ry., 260 F.2d 663 (8th Cir. 1958). See also Code §381(c)(16) and Reg. §1.381(c)(16)-1(a)(5).
that the patent infringement lawsuit was not a factor in the decision to reduce the purchase price. In concluding that the liability had been assumed, the Seventh Circuit noted:

[The taxpayer] knowingly assumed the [patent infringement] lawsuit as part of the purchase agreement for the [seller's] assets. Because [the taxpayer] agreed to pay that contingent liability in exchange for [the seller’s assets], that contingent liability formed part of the purchase price.197

In *Illinois Tool Works*, the Seventh Circuit viewed the failure of the purchaser to reduce the purchase price simply as a failure to take steps to mitigate the known risk posed by the patent infringement lawsuit. Therefore, the fact that the parties have reduced the purchase price provides evidence that a liability has been assumed; however, the fact that the parties did not reduce the purchase price does not necessarily provide evidence that the liability was not assumed.198

5. *Whether the Liability Arose from Actions of Seller or Buyer*

The IRS and the courts often look to whether the actions of the seller or the buyer gave rise to the liability. In general, if the liability arose from decisions made by the buyer, then the liability is not treated as an assumed liability of the seller.199

This factor is evident in cases involving the deductibility of severance payments.200 For example, in IRS TAM 9721002, the purchaser bought the stock of target. Several days after the acquisition, the purchaser issued termination notices to certain target employees. In holding that the purchaser could deduct the severance payments paid to the terminated target employees, the IRS noted that the purchaser was "free to decide after the acquisition whether to terminate employees and become liable." In other words, the act which triggered liability for the severance payments was the buyer's decision to terminate target employees. This appears to be true even where the agreements giving rise to the obligation to make severance payments were negotiated between the seller and its employees prior to the acquisition.201

6. *Was the Buyer Aware of the Liability?*

The fact that a buyer was aware of a liability at the time of purchase provides evidence that the liability was assumed. The fact that the buyer was aware of the patent infringement suit clearly influenced the Seventh Circuit's holding in *Illinois Tool Works*. The fact that a taxpayer may have made a bad bargain is unavailing in the determination of whether a liability was assumed. As stated by the Seventh Circuit:

Part of [the taxpayer's] process of valuing the [seller's] assets and arriving at the purchase price included evaluating the [patent infringement] lawsuit. In that due diligence phase, [the taxpayer] assessed a value to the suit based on how it foresaw the litigation unfolding once it took control of the defense. Its ability to affect the outcome of the [patent infringement] lawsuit was therefore already factored in. That things did not go according to plan, and that, in retrospect, it should have

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197 355 F.3d at 1002.
198 But see Reg. §1.381(c)(16)-(o)(5), setting forth a presumption that if the purchase price is not reduced, the obligation is not considered to be reflected in purchase price and, thus, is not assumed, regardless of whether the parties were or were not aware of the liability.
199 See and compare Holdercroft Transp. Co v. Commissioner, 153 F.2d 323 (8th Cir. 1946) (holding that a tort claim paid by the transferee in a Code §351 transaction had to be capitalized, because the tort claim had been asserted); Albany Car Wheel Company, Inc. v. Commissioner, 40 T.C. 831 (1963), aff'd, 333 F.2d 653 (2d Cir. 1964) (holding the liability to pay severance wages arose from the decision of the buyer to close the plant and pursuant to a union contract negotiated by the buyer; liability was not an assumed liability of the seller).
200 Rev. Rul. 67-408; IRS TAM 9721002 (1/24/97); IRS TAM 9731001 (1/31/97).
201 In IRS TAM 9721002, the agreements giving rise to the obligation to make severance payments arose from certain agreements the target had with its employees. Senior executives had entered into "termination protection agreements" with the target. Salaried employees not having individual employment contracts with target had rights to severance benefits under the personnel policy of target.
paid far less for [the seller] to account for size of the judgment assigned, does not change the tax character of the judgment in this case. 202

Similarly, in Pacific Transport Company v. Commissioner, 203 a parent corporation liquidated its subsidiary and subsequently paid the claims asserted against the subsidiary for losing certain cargo at sea. The Ninth Circuit noted that although the purchase price was not discounted for the cargo loss liability, the parties were aware of the contingent liability and that the parent took the subsidiary's assets on liquidation subject to the liability. The court went on to note that capitalization is required even "where taxpayers enter into bargains, proceed under a mistake of law or fail to realize the substance or amount of the liability assumed." 204

Based on the foregoing cases, if the buyer is aware of a liability, the liability will generally be viewed as an assumed liability. On the other hand, where the buyer was not aware of the liability, an argument may be made that the liability was not assumed. However, this factor has not been determinative where the liability arose out of actions by the seller or from preacquisition events. 205

B. Code §1060

Code §1060 requires the purchaser and seller each to allocate the consideration paid and received in the transaction among the assets transferred using the residual method. Code §1060 applies to an "applicable asset acquisition," which is generally defined as any transfer of a trade or business where the purchaser's basis is determined wholly by reference to the purchaser's consideration. For purposes of determining the buyer's cost of the assets and the seller's gain on the assets, the regulations under Code §1060 specifically provide that the buyer's consideration is the cost of the acquired assets and the seller's consideration is the amount realized on the applicable asset acquisition 206 and that general tax principles apply in making these determinations.

As noted above, the regulations under Code §1060 are silent on contingent liabilities. Because the regulations refer to general tax principles for purposes of determining the buyer's cost and the seller's gain, it would seem to follow that if a contingent liability can be valued—e.g., through some sort of probability discounting—it should be taken into account by both the buyer and seller at the time of the transaction. That is, the transaction should be closed with respect to that liability (possibly subject to later adjustment). 207

1. Treatment of Buyer in Actual Asset Sale under Code §1060 (In General)

The buyer's treatment with respect to contingent liabilities is not altogether clear. There are a number of questions, e.g., whether a contingent liability is capitalized immediately, capitalized when paid, or deducted when paid. Also, a question exists as to whether Code §461(h) limits a taxpayer's ability to capitalize or deduct a contingent liability. There are three possible approaches.

   a) Capitalize Immediately

Under general tax principles, it could be argued that a buyer should immediately obtain basis for assuming a contingent liability, to the extent that a value is placed on the liability. In such a case, the assumption of the contingent liability is generally reflected in the purchase price, i.e., the buyer will reduce the purchase price by the value placed on the liability. For example, if the buyer was otherwise prepared to pay $1,000 in cash for the assets of a business but takes it subject to a contingent liability that

202 355 F.3d at 1003.
203 483 F.2d 209 (9th Cir. 1973).
204 483 F.2d at 213.
205 See, e.g., Holdcroft, 153 F.2d at 323; Webb, 77 T.C. at 1137, aff'd, 708 F.2d 1254 (7th Cir. 1983).
206 See Reg. §1.1060-1(c).
207 Compare Reg. §15A.453-1(d)(2)(iii) (stating that only in rare and unusual circumstances will open transaction reporting be permitted).
is valued by the parties at $100, the buyer will discount the cash payment to $900. Thus, the basis (and amount realized to the seller) arguably should be $1,000: the $900 cash paid and the assumption of the $100 liability. This approach is consistent with closed transaction reporting, which the Service clearly favors as reflected in the "elect out" provisions of the Code §453 regulations.\(^{208}\) There is no clear guidance on this point.

The Service, however, will challenge taking basis into account until the liability is economically performed.\(^{209}\) Code §461 and Reg. §1.461-1(a)(2) specifically provide that a liability may not be treated as incurred until the "all events test" is met, including economic performance. In other words, a contingent liability cannot be taken into account until three requirements are met: (1) all events have occurred that establish the fact of liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred. Therefore, if economic performance has not occurred, a position that the buyer can take basis immediately may be precluded under Code §461.

On the other hand, it may be argued that when a contingent liability is assumed that economic performance has effectively taken place. In the example above, if the buyer had paid the seller $1,000 and the seller paid off the contingent liability for $100, it is clear that the buyer would have a basis of $1,000 in the purchased assets. Because the situation whether the buyer pays the seller $900 and assumes the contingent liability is, in essence, economically equivalent to the situation where the buyer pays $1,000 and the seller pays the contingent liability, arguably the buyer's basis under both scenarios should be the same. Nevertheless, it seems likely that the IRS will challenge the taking of basis immediately in situations where the contingent liability is assumed by the buyer.

If a buyer does take basis immediately, there is the additional question of whether amounts later paid in excess of the amount capitalized must be capitalized or may be deducted. Again, there is no clear guidance on this point, but Arrowsmith v. Commissioner\(^{210}\) would seem to require that such amounts be treated as part of the original transaction for purposes of determining deductibility or capitalization.

**b) Capitalize When Economically Performed (IRS Preferred Approach)**

Authority exists for the proposition that a contingent liability is not included in basis until it ripens into a fixed liability and is economically performed. This appears to be the position most frequently adopted by the courts and the IRS.\(^{211}\) For example, in David R. Webb,\(^{212}\) the buyer assumed an obligation to pay an unfunded pension liability. Affirming the Tax Court's decision, the Court of Appeals for the Seventh Circuit held that the payments were capital expenditures that became part of the cost basis of acquired assets when paid. Not only is this position arguably the most consistent with the requirements set forth in Code §461, but it also appears to be consistent with recent court decisions. In Amergen Energy Co. v. U.S., the taxpayer had acquired a nuclear power plant and assumed contingent nuclear decommissioning liabilities.\(^{213}\) The Court of Claims held that the taxpayer could not include the decommissioning liabilities...
in its basis until the all events test had been met. *Amergen* is the first case to explicitly hold that the economic performance requirements apply to assumed liabilities.\(^{214}\)

c) Immediate Deduction When Paid

There is other authority indicating that a taxpayer may be entitled to a deduction when a contingent liability becomes fixed. As indicated above in *David R. Webb*, the Seventh Circuit required contingent liabilities to be capitalized when paid. However, in *Pacific Transport*, the Tax Court ruled the contingent liability could be deducted when paid. The court reasoned that a deduction should be allowed upon payment of the liability, because the liability was so speculative that the parties could not have intended the liability to be reflected in the costs of the assets. Similarly, in *Albany Car Wheel*,\(^{215}\) the Tax Court held that a buyer of a business could not immediately include in the basis of the assets its liability for severance pay under a union contract renegotiated by the buyer at the time of purchase. The court further noted that an obligation that may actually result in a fixed liability in a later year should properly be taken into account as a deduction in the later year. This treatment is also consistent with Code §§381(c)(14) and (c)(4), which adopt similar principles in the context of a §381 transaction.\(^{216}\)

It might be argued that authorities such as the Tax Court decisions in *Pacific Transport* and *Albany Car Wheel* do not support the position that an assumed contingent liability may be deducted. Instead, it can be argued that these cases dealt with liabilities that were not preexisting liabilities of the seller that were assumed, but were instead liabilities of the buyer that arose after the acquisition, in which case, a deduction by the buyer would be appropriate.

2. **Buyer's Treatment of Assumed Deferred Compensation Liabilities in Actual Asset Sale under Code §1060**

As previously stated, generally, purchasers are not entitled to deduct payments made to discharge liabilities of the seller assumed in a purchase. However, post-acquisition contributions made by purchasers to qualified pension plans with respect to employees of the seller are generally not treated as the payment of an assumed liability, required to be capitalized as part of the purchase price, even if such contribution may have some relation to services performed by the employees prior to the transaction. As discussed below, in GCM 39274\(^{217}\), the Service held that only certain post-acquisition contributions made to a qualified plan in very specific factual circumstances constitute payment of assumed liabilities.

a) Qualified Pension Plans

The IRS has opined that certain liabilities in connection with a buyer's assumption of a seller's qualified pension plan are deductible when paid. Under such plans, the employer promises to pay a benefit to its employees based on a formula that generally takes into account each employee's final compensation and total years of service. Code §412 requires an employer to make an annual contribution to the plan to fund this benefit, which is based on the employee's current compensation and years of service worked as of that year. If an employer fails to make a sufficient contribution, the plan will not have met its "minimum funding standard" and an excise tax will be imposed. For any given year, the amount an employer is required to contribute to a pension plan will be substantially less than the funding required to pay benefits at a given employee's retirement age. This is because an employee's potential compensation increases are not taken into account for funding purposes until the year in which those increases occur.

In general, under Code §404(a)(1), contributions to a qualified plan are deductible in the year of contribution. A qualified plan described in Code §404(a)(1) is funded - that is, assets are set aside to pay

\(^{214}\) See and compare Treas. Reg. 1.338-5(b)(2)(ii), Ex. 2 (holding that an assumed environmental remediation obligation is not taken into account for purpose of AGUB until economic performance occurs).

\(^{215}\) Albany Car Wheel, 40 T.C. at 831.

\(^{216}\) The treatment of contingent liabilities in a Code §381 transaction is discussed in detail below.

\(^{217}\) Gen. Couns. Mem. 39274 (8/16/84).
deferred compensation in a trust that is outside the reach of the employer's creditors. In addition, a qualified plan under Code §404(a)(1) must meet the requirements for qualification set forth in Code §401 - a "qualified plan" must be "created or organized in the United States" and must be "for the exclusive benefit of... employees or their beneficiaries."

Further, under Code §162, a taxpayer may deduct ordinary and necessary expenses incurred in the conduct of its own trade or business. However, payment of another's expenses generally will not give rise to a trade or business deduction for the taxpayer because the expenses are not incurred by the taxpayer in its trade or business. In general, contributions to a qualified plan under Code §404(a)(1) are deductible, provided the requirements of Code §162 and Code §404 are met. If, on the other hand, the taxpayer assumed a liability to make contributions to a qualified plan, then the cost must be capitalized.

b) Treatment of Assumed Liabilities Related to Qualified Pension Plans

As discussed more fully above, generally a purchaser's assumption of a liability of the seller, whether fixed or contingent, in a taxable asset acquisition is treated as an amount paid for the assets and is capitalized by the purchaser and added to the basis of the acquired property, either at the time of the acquisition or later, depending on when it is properly taken into account under Code §461. Consequently, a purchaser cannot obtain basis for an assumed liability until all the requirements of Code §461, including economic performance, are met with respect to the liability and, in the case of an assumed liability relating to a pension plan, Code §404.

The circumstances under which a purchaser is viewed as assuming a liability arising from a pension plan maintained by the seller depends in part on whether the plan is a nonqualified plan under Code §404(a)(5) or a qualified plan under Code §404. Specifically, in the case of a nonqualified plan under Code §404(a)(5), the central inquiry appears to be whether the payments at issue relate to services that were performed preacquisition. In contrast, the central inquiry in the case of qualified plans under Code §404(a)(1) is not whether the payments relate to preacquisition services performed by an employee.

The primary authority addressing whether post-acquisition contributions by the acquirer to qualified plans acquired in connection with a taxable asset acquisition constitute assumed liabilities is GCM 39274. In GCM 39274, in connection with a taxable asset acquisition, the purchaser acquired a defined benefit pension plan qualified under Code §401(a) that had been maintained by the predecessor plan sponsor (i.e., the seller). At the time of the acquisition, the plan had an unfunded past service liability but no accumulated funding deficiency under Code §412. The GCM concluded that because the buyer does not

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218 For example, in Welch v. Helvering, 290 U.S. 111, 114 (1933), the Supreme Court refused to permit a deduction for payments made by a taxpayer on behalf of a bankruptcy company. See also Williams v. Commissioner, T.C. Memo. 1960-19 (finding amounts paid as a settlement for timber cut from another's property was nondeductible because the underlying action, the reason for the settlement payment, was the responsibility of the taxpayer's sons, not of the taxpayer, such that the payment was made from a moral and not a business obligation); Lohrke v. Commissioner, 48 T.C. 679 (1967), acq. 1968-2 C.B. 2 (citing decisions in which the courts have denied a deduction for payments made on behalf of another, including Dodd v. Commissioner, 298 F. 2d 570 (4th Cir. 1962); Jean U. Koree, 40 T.C. 961 (1963); S. M. Howard, 39 T.C. 833 (1963); and Charles Gran Mensik, 37 T.C. 703 (1962), aff'd, 328 F.2d 147 (7th Cir. 1964), cert. denied 379 U.S. 827 (1964).

219 United States v. Smith, 418 F.2d 589 (5th Cir. 1969); Rev. Rul. 76-520, 1976-2 C.B. 42. Treas. Reg. §1.060-1(c)(1); Treas. Reg. §1.1060-1(d), Ex. 2(f). See also the cases cited in the sections above.

220 See, e.g., Treas. Reg. §1.1338-5(b)(2)(ii), Ex. 2(g), which concludes that a purchaser does not obtain basis for an assumed environmental remediation liability until the liability is economically performed.

221 Code §404(a)(5) provides that in a case of a nonqualified plan, any contributions made pursuant to the plan are deductible in the taxable year in which the amount attributable to the contribution is includible in the gross income of the employees participating in the plan.

222 See, e.g., David R. Webb v. Commissioner, 77 T.C. 1134 (1981), and 708 F.2d 1524 (7th Cir. 1983), where payments made under a non-qualified pension plan were held to be a discharge of an assumed liability. The court found that the time the employees performed services that were covered by the pension plan is determinative of whether a liability related to a pension plan is an assumed liability.
have a contractual liability to continue making minimum funding liability payments or past service liability payments, the buyer's choice to maintain such a plan is discretionary and constitutes the buyer's own ordinary and necessary business expense. This view is supported by Code §404, which expressly grants an employer a deduction for payments in satisfaction of a qualified pension liability when paid if within statutorily prescribed percentages.

Significantly, in GCM 39274, the Service identified three types of liabilities associated with a qualified plan that would constitute assumed liabilities. These three liabilities are (i) a liability to the Pension Benefit Guaranty Corporation (PBGC) upon termination of the plan; (ii) a liability to plan participants for unpaid benefits beyond those guaranteed by the PBGC; and (iii) a liability to pay any accumulated funding deficiencies. With regard to these three liabilities, GCM 39274 states:

There are a number of liabilities of a selling company relating to its defined benefit plan which if assumed by the acquiring company could not be unilaterally extinguished by the latter and could thus be said to be seller's liabilities which have accrued. One is the liability to the Pension Benefit Guaranty Corporation (PBGC) upon termination of the plan to reimburse PBGC for insured benefits paid to plan participants and their beneficiaries. This amount would be the amount of the seller's liability to PBGC if the plan were terminated at the time of the asset sale and would be added to the purchaser's basis at the time the liability became fixed and capable of being valued with reasonable accuracy. Another is the liability by the plan to plan participants for unpaid benefits beyond those guaranteed by PBGC. See Murphy v. Heppenstall Co., 635 F.2d 233 (3rd Cir. 1980), which held that participants in a terminated plan under certain circumstances are entitled to recover unfunded amounts promised under the plan that are in excess of amounts insured and paid by PBGC directly from the employer. This liability would be the plan liability in excess of the amount owed to PBGC if the plan were terminated at the time of the asset sale. This second liability is essentially the same liability that was assumed by the taxpayer in Webb, as the participants have a legal right to enforce the benefits promised to them. The third is the liability to pay amounts that are past due under the plan's funding standard account at the time of the acquisition, i.e., any accumulated funding deficiency as defined in Code §412(a).

Further, there are a number of authorities holding that a purchaser can deduct contributions that relate to preacquisition services because the purchaser "steps into the shoes" of the target with regard to contributions made to a qualified plan for target corporation employees. For example, in IRS Letter Ruling 8205022, Company M adopted Plan X, a defined benefit pension plan, effective December 1, 1972, and completely restated the plan as of December 1, 1976. On December 1, 1977, Plan X was frozen. After that date, there were no additional employees eligible to participate in Plan X and the only contributions made were to fund Plan X's unfunded frozen liability. On June 1, 1981, Company N acquired all the assets and certain liabilities of Company M in consideration for cash and installment notes. The Service held that Company N could deduct contributions made by Plan X and that no part of the contributions would constitute part of the purchase price paid by Company M for the Company N assets.

It should be noted that in 1994 FSA 490, the Service reaffirmed the rationale in GCM 39274 in holding that post-acquisitions made by an acquiring corporation to a qualified pension plan maintained by the
target were deductible. Significantly, the Service noted that the Supreme Court itself has seemed to generally view pension contributions as an exception to the norm of capitalization for expenditures incurred in acquiring capital assets, citing *Idaho Power v. Commissioner.*

c) Nonqualified Deferred Compensation

In the case of a nonqualified plan, which may be funded or unfunded, Code §404(a)(5) generally provides that the contributions or compensation paid or accrued on account of any employee under the plan are deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. Further, Reg. §1.404(a)-12(b)(1) provides that a deduction is allowable for a contribution "only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation." However, when a purchaser makes a payment arising from an unfunded, nonqualified pension plan maintained by the seller, such payments constitute an assumed liability that must be capitalized. As noted above in Webb, the Service asserted that the payments were part of the purchase price paid for the assets, and that the taxpayer should have capitalized those amounts into the basis of the assets acquired. The Seventh Circuit agreed with the Service and found that the time the employees performed services that were covered by the pension plan is determinative of whether a liability related to a pension plan is an assumed liability. Further, the Seventh Circuit recognized that increasing the buyer's tax basis for an assumed liability only when payments are actually made is consistent with the policies underlying §404.

Payments by the buyer to former seller employees, for services performed for the seller, under a nonqualified deferred compensation plan are generally an addition to the purchase price and are not deductible by the buyer but rather would be an addition to the buyer's basis in the assets purchased when paid.

3. Buyer's Treatment of Assumed Deferred Revenue Liabilities in Actual Asset Sale under Code §1060

There are significant issues that arise when a buyer assumes a liability associated with prepaid income of the seller that the seller has elected to defer under various statutory, regulatory and administrative provisions. When the seller is relieved of its obligation to perform under the agreements giving rise to the deferred revenue because the purchaser has assumed such obligation, the seller is required to recognize previously deferred amounts.

This section focuses on the treatment of the buyer where a liability associated with deferred revenue of the seller has been assumed. Most of the guidance in this area arises in the context of prepaid subscription liabilities which the seller has elected to defer under Code §455. The authorities addressing the tax consequences to the buyer who has assumed a prepaid subscription liability of the seller are confusing.

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224 The Supreme Court stated that "[t]he clear import of section 161 is that, with stated exceptions set forth either in section 263 itself or provided for elsewhere (as, for example, in section 404 relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible." 418 U.S. 1, at 17 (1973).

225 The timing of an employee's income inclusion is dependent on whether the deferred compensation plan is funded or unfunded. If the deferred compensation plan is funded (i.e., through the use of a secular trust), the employee generally is taxed on his or her interest in the secular trust when the interest becomes substantially vested. See Code §402(b); Reg. §§1.402(b)-1 and 1.83-1(a)(1). However, if a plan is unfunded, the employee is not taxed until the deferred amount is actually or constructively received. See Reg. §1.451-1(a).


227 For example, Code §455, Code §456, Rev. Proc. 2004-34, and Reg. §1.451-5 provides for the deferral of certain advance payments.

228 See, e.g., Reg. §1.455-4; Reg. §1.451-5(f); Rev. Proc. 2004-34 §5.02(5).
Based on these authorities, there appear to be three possible approaches to analyze the tax consequences to the buyer. First, there are authorities indicating that a deferred revenue liability is treated the same as any other assumed liability—that is, it is capitalized to the basis of the acquired assets when it is economically performed (the "assumed liability approach"). Second, in situations where the seller makes a separate cash payment to the buyer, the transaction is bifurcated into two components: (1) the purchase of assets; and (2) a separate payment to the buyer for the buyer's agreement to perform the seller's prepaid subscription liability (the "bifurcation approach"). Finally, in situations where the seller and the buyer reduce the purchase price, the IRS has applied the bifurcation approach to treat the transaction as (1) the purchase of assets; and (2) a deemed separate payment by the seller to the buyer in the amount of purchase price reduction to the buyer for the buyer's agreement to perform the seller's prepaid subscription liability (the "deemed payment approach").

The application of the bifurcation approach when a separate payment is made by the seller to the buyer seems reasonably clear. It is unclear, however, when the assumed liability approach or the deemed payment approach would apply. Specifically, does the deemed liability approach apply any time the parties take liabilities on the books of the target into account in determining the purchase price? Does the deemed payment approach only apply when the contract between the parties specifically provides for a reduction in purchase price for the deferred revenue liability? Based on the authorities discussed below, it appears that the IRS has adopted a formalistic approach to the application of the deemed payment approach. That is, the deemed payment approach applies only when there is a specific contractual provision reducing the purchase price for the deferred compensation liability.

a) Assumed Liability Approach

Some authorities treat a liability to fulfill a prepaid subscription liability assumed by the buyer the same as any other assumed liability. That is, the buyer gets an increase in the basis of assets purchased from the seller when the liability is economically performed pursuant to Code §461, but does not recognize income from the deferred revenue and cannot deduct expenses incurred in fulfilling the deferred revenue liability. The IRS adopted the assumed liability approach with respect to deferred revenue in Rev. Rul. 76-520. Under the facts of Rev. Rul. 76-520, P purchased the stock of S, a publishing corporation, and subsequently caused S to be liquidated under former Code §334(b)(2). Under former Code §334(b), the transaction was, in effect, treated as an acquisition of S's assets by P. S had prepaid subscription contracts and, in the liquidation, P assumed S's liability to fulfill the prepaid subscriptions. The cost to fulfill the prepaid subscriptions was $500x. The IRS held that P was not entitled to deduct the $500x cost to fulfill the prepaid subscriptions. Instead, P was required to capitalize this amount to the basis in assets acquired from S.

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230 See Rev. Rul. 76-520, 1976-2 C.B. 42; FSA 20048002 (5/22/00); FSA 1999841.
231 A taxpayer generally does not realize gross income upon its purchase of a business's assets, even where those assets include cash or marketable securities and, in connection with the purchase, the taxpayer assumes liabilities of the seller. See, e.g., Palmer v. Commissioner, 302 U.S. 63, 69 (1937); Commissioner v. Oxford Paper, 194 F.2d 190 (2d Cir. 1951); Rev. Rul. 55-675, 1955-2 C.B. 567.
232 See Reg. §1.338-5(b)(iii), example (2), which provides that a buyer does not get basis for an assumed environmental remediation liability until the liability is economically performed.
234 Code §334(b)(2) was enacted in 1954 as a response to the holding in Kimball-Diamond Milling Co. v. Commissioner, 14 T.C. 74, aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied 342 U.S. 827 (1951). In Kimball Diamond, a stock acquisition followed by a liquidation of the acquired corporation was treated as a direct acquisition of the assets of the acquired corporation (i.e., the Kimball-Diamond doctrine). See generally, S. Rep. No. 1662, 83d Cong., 2d Sess. 257 (1954).
235 The IRS followed the approach in Rev. Rul. 76-520 in Field Service Advice 1999841. In Field Service Advice 1999841, in connection with a taxable asset sale, the taxpayer assumed liabilities of the seller, including the obligation to produce and deliver copies of a publication to existing prepaid subscribers. Citing Rev. Rul. 76-520 and the underlying Gen.
Rev Rul. 76-520 does not address the timing of P’s basis increase for the assumed liability to fulfill the prepaid subscriptions. It is important to note that at the time Rev. Rul. 76-520 was published, the economic performance requirement of Code §461(c) had yet to be enacted. Under current law, P would get additional basis for the $500x liability to fulfill the prepaid subscriptions as the liability was performed. The following example illustrates this concept:

**Example 1** - P purchased all the assets of T, a publishing corporation, and assumed T’s liabilities to fulfill prepaid subscriptions. The assets had a fair market value of $500x and the cost to fulfill the prepaid subscriptions was $100x. Under the terms of the purchase agreement, P paid $400x for the assets and assumed the liability to fulfill the prepaid subscriptions. P has immediate basis of $400x in the assets and will obtain an addition $100x of basis as the liability to fulfill the prepaid subscriptions is economically performed.

b) The Bifurcation Approach

In situations where the seller makes a separate payment to the buyer to compensate the buyer for the assumption of a deferred revenue liability, the IRS seems to accept the form of the transaction as two separate and distinct transactions. In other words, the transaction between the buyer and the seller is deemed to consist of (1) the purchase of assets; and (2) a separate payment to the buyer for the buyer’s agreement to perform the seller’s prepaid subscription liability. Specifically, in Rev. Rul. 71-450, the IRS ruled that the amount paid by the seller of a newspaper to the purchaser who assumed liability for unearned subscriptions is includible in the purchaser’s gross income. Under the facts of the ruling, the seller received 5x dollars as the sales proceeds, which did not take into account the seller’s liability for existing newspaper subscriptions. The seller paid the purchaser 1x dollars, a sum equal to the amount of prepaid subscriptions existing at the time of the sale, to compensate the purchaser for assuming the seller’s liability on the subscriptions. Under these facts, the IRS concluded that the buyer had gross income under Code §61 equal to the 1x dollars it received from the seller.

Another important point in the analysis is the amount of basis obtained by the buyer. In Rev. Rul. 71-450, the IRS does not specifically address the buyer’s basis in the purchased assets; implicit in the ruling, however, is that the buyer gets full basis in the assets. As one of the facts of Rev. Rul. 71-450, it is specifically stated that the purchase price of the assets does not reflect the prepaid subscription liability. Presumably, under Code §1012, the buyer gets immediate basis in the assets equal to the purchase price, which was not reduced to take into account the prepaid subscription liability.

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Couns. Mem. 36155, the IRS held that the costs to fulfill the prepaid subscriptions were capitalized to the basis of the acquired assets. See also, IRS Letter Ruling 8433007 (citing Rev. Rul. 76-520, in holding that, in the context of a taxable liquidation under §331, the shareholders of the liquidating corporation could not deduct costs assumed in the liquidation associated with fulfilling prepaid contracts for goods for which the liquidating corporation had deferred advance payments under Reg. §1.451-5). See also, Meredith Corp. v. Commissioner, 102 T.C. 406 (1994) (Meredith I) and Meredith Corp. v. Commissioner, 108 TC 89 (1997) (Meredith II), where the Tax Court stated in dicto that the taxpayer (the purchaser in the taxable asset acquisitions) could not deduct assumed deferred liabilities related to prepaid subscriptions. Outside of the deferred revenue context, Rev. Rul. 76-520 is often cited by the IRS for the general proposition that the assumption of a liability, whether or not the liability was fixed or contingent at the time the property was acquired, does not give rise to a deduction when the liability is paid, but is instead capitalized and added to the basis of the acquired property. See, e.g., IRS Letter Ruling 200730014 (5/1/07); 2000 IRS CCA Lexis 263; Field Service Advice 200048006 (8/14/00); IRS Letter Ruling 9721002 (1/24/97).

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See, e.g., Example 2 in Reg. §1.338-5(b)(iii) (which requires that a contingent liability be economically performed before a buyer gets basis).

1971-2 C.B. 78. The Preamble to Reg. §1.1502-80, which provides guidance on the way in which the items of a liquidating corporation are succeeded to, and taken into account, when multiple members acquire the assets of the liquidating corporation in a complete liquidation to which Code §332 applies, cites Rev. Rul. 71-450 favorably. Refer to the Preamble for additional details.
Example 2 - P purchased all the assets of T, a publishing corporation, and assumed T's liabilities to fulfill prepaid subscriptions. The assets had a fair market value of $500x. T had advance payments for subscriptions in the amount of $150x, which are deferred under Code §455, and the estimated costs to fulfill the prepaid subscriptions was $100x. Under the terms of the purchase agreement, S paid P $150x to compensate P for assuming T's liabilities on these subscriptions. The sales price of $500x was not reduced to take into account S's liability for the prepaid newspaper subscriptions. P (1) recognizes income in an amount equal to the seller's $150x payment,238 the recognition of which may be deferred under §455;239 (2) gets basis in the amount of $500x;240 and (3) gets a deduction for the costs of fulfilling the prepaid subscription liability.241

The assumed liability approach set forth in Rev. Rul. 76-520 and the bifurcation approach set forth in Rev. Rul. 71-240 may appear to be inconsistent; however, they can be reconciled. Specifically, Rev. Rul. 76-520 involved the purchase of the stock of the target, which had liabilities associated with deferred subscription revenue. As a stock purchase, there was presumably no specific negotiation regarding a payment or reduction in the purchase price for the liabilities associated with the deferred subscription revenue. In contrast, in Rev. Rul. 72-340, there was a specifically negotiated separate payment intended to compensate the buyer for assuming the liabilities associated with the deferred subscription revenue. That is, where there is no specific negotiation, the assumed liability approach set forth in Rev. Rul. 76-520 applies.

c) Deemed Payment Approach

In some transactions, rather than having the seller make a payment to the buyer, the assumption of a prepaid subscription liability by the buyer is taken into account by the parties through a reduction in purchase price. In Gen. Couns. Mem. 34418242 and in two private letter rulings,243 the IRS took the position that situations in which the purchase price is reduced to reflect the prepaid subscription liability are, in substance, the same as situations where the seller pays the buyer to assume the prepaid contingent liability. Based on this analysis, the IRS applied the bifurcation approach set forth in Rev. Rul. 71-450 and treated the transaction as (1) the purchase of assets; and (2) a separate payment to the buyer for the buyer's agreement to perform the seller's prepaid subscription liability. Consequently, the tax consequences to the buyer are the same as that when the seller makes a separate payment.

Example 3 - The facts are the same as Example 2, except that instead of making a payment to compensate P for the costs of fulfilling the liabilities, the purchase price of $500x is specifically reduced by $150x to $350x to compensate P's assumption of T's prepaid subscription liabilities. The tax consequences to P are the same as when T makes a separate payment. That is, P (1) recognizes income in an amount equal to the seller's $100x payment, the recognition of which may be deferred under §455; (2) gets basis in the amount of $500x;244 and (3) gets a deduction for the costs of fulfilling the prepaid subscription liability.

Under this analysis, the timing of the basis increase to the buyer is unclear, particularly in situations where the recognition of income by the buyer is deferred under Code §455. Gen. Couns. Mem. 34418 specifically states that the buyer receives a basis increase as a result of the recognition of income. This

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239 See, e.g., IRS Letter Ruling 8749076 (9/11/87); IRS Letter Ruling 8612050 (12/23/85).
241 See, e.g., IRS Letter Ruling 8749076 (9/11/87); IRS Letter Ruling 8612050 (12/23/85).
242 IRS Letter Ruling 8749076 (9/11/87); IRS Letter Ruling 8612050 (12/23/85).
would suggest that if the recognition of income were deferred, the buyer would not receive a correlative basis increase until the income is recognized.

In contrast, in IRS Letter Ruling 8749076, which involved a reduction in purchase price, the Service specifically stated that a reduction in purchase price was indistinguishable from the situation in Rev. Rul. 71-450. As noted above, in Rev. Rul. 71-450, the transaction involved a payment by the buyer equal to the full fair market value of the assets and a separate out-of-pocket payment by the seller to compensate the buyer for the assumption of the prepaid subscription liabilities. Arguably, under the rationale in IRS Letter Ruling 8749076, in situations where the purchase price is reduced, the buyer should be viewed as paying full fair market value for the purchased assets and, therefore, would immediately receive full fair market value basis in the property.

The IRS views the deemed payment approach as elective and applies this approach only when there has been a specific reduction in the purchase price for the assumed deferred revenue liability that is reflected in the agreement between the parties. That is, the IRS will treat the buyer as having received a payment from the seller for the deferred revenue liabilities only when it is clear that the parties have negotiated such a payment, either through an actual separate payment or a specific contractual reduction in purchase price for the deferred revenue liability. Although it would seem that a purchaser normally would not want the deemed payment approach to apply, it may be a negotiating point in the deal. Specifically, if the seller does not want to be taxed on the profit inherent in the deferred revenue, the deemed payment approach results in the buyer bearing the profit from the prepaid subscription liabilities equal to the difference between the income resulting from the reduction in purchase price (or the payment by the seller) and the amount of the expenses to fulfill the deferred revenue liability.

In the absence of a specific reduction in purchase price (or a payment by the seller), under Pierce, the seller would be entitled to a deduction equal to the costs to fulfill the deferred revenue liability (which is not necessarily the same as the deferred revenue that is triggered as a result of the asset sale). As a result, the seller is taxed on the profit inherent in the prepaid subscriptions. By specifically reducing the purchase price (or making a payment), the seller can move some or all of the profit to the buyer. It would not seem appropriate to tax the buyer on the profit inherent in the prepaid subscriptions of the seller unless it is clear that the purchaser has agreed to this result as evidenced by a specific contractual reduction in purchase price (or a payment by the seller).

Applying a formalistic approach is consistent with the treatment of assumed liabilities under Code §381. Under §381, the transferee generally "steps into the shoes" of the transferor under Code §381(c)(16) and underlying regulations. Step-into-the-shoes treatment is allowed unless the liability is reflected in the amount of consideration transferred. Several examples in the Code §381(c)(16) regulations indicate that a

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For example, Gen. Couns. Mem. 34418 (2/6/80), which is the basis of the deemed payment approach, specifically states that "[t]here is no warrant for assuming that the 'payment' by the taxpayer-seller to the buyer of its assets 'equal[ed] the advance receipts.' The deduction that is allowable must not only be supported by the sales contract (i.e., the amount shown in the contract as the sales price reduction), but it must also be supported by the existing circumstances." Further, in 1993 FSA LEXIS 104, the IRS stated as follows: "[t]he seller of a business will often compensate the buyer for assuming liabilities, either by direct payment or by a reduction in the purchase price. In Rev. Rul. 71-450, 1971-2 C.B. 78, the Service ruled that a buyer must include in its gross income under section 61(a) an amount received from the seller to compensate it for assuming the seller's liability for unearned subscription income. Normally the Service will not recognize the existence of a payment as a purchase price reduction unless the parties specify an amount in an arms' length transaction." As another example, in IRS Letter Ruling 8612050, where the IRS applied the deemed payment approach to New Target in the context of a Code §338 transaction, the taxpayer specifically represented that there was a specific contractual reduction in the purchase price of the target stock for the deferred revenue liabilities. Finally, it is relevant to note that in numerous private letter rulings addressing the tax consequences to the purchaser of nonqualified decommissioning liabilities, the IRS held that a purchaser did not have income as a result of the acquisition of the seller's nonqualified decommissioning fund (i.e. that the holding set forth in Rev. Rul. 71-450, 1971-2 C.B. 78, is an exception to the general rule).
liability generally will not be considered to have been reflected in the amount of consideration transferred if no specific reduction in consideration occurred to take into account the specific obligation.

In addition, this approach is consistent with the views of some commentators who believe there is no good policy reason to automatically extend the deemed payment approach to the purchaser. The author is of the same view. That is, the purchaser should not be forced to have income recognition simply because it has assumed a liability relating to deferred revenue. Rather, the purchaser should have income only when it is clear that the parties intended that seller compensate the purchaser for the assumption of the deferred revenue liability.

4. **Treatment of Seller under Code §1060**

Again, the regulations under Code §1060 defer to general tax principles. In general, the seller's amount realized should be increased by the amount of the assumed liabilities. However, this raises several corollary issues. First, there is the timing of the income recognition that arises because of the assumption of a contingent liability. Second, there are authorities that suggest that a seller is entitled to an offsetting deduction for any amount realized as the result of assumed contingent liabilities, resulting in no net income to the seller.

a) **Timing of Income Recognition**

In general, there are two approaches relating to the timing of recognition by a seller from the assumption of a contingent liability. Under the first approach, the contingent liability would be valued at closing and the seller's amount realized would be increased by this amount. If the amount of the liability later proved to be more or less, the amount realized by the seller would presumably be adjusted at that time under the principles of *Arrowsmith v. Commissioner.* This treatment, in essence, results in "closed" transaction treatment for the seller.

**Example** - A buyer purchases the assets of a seller and assumes a contingent liability to settle a patent infringement lawsuit. The parties value the claim at $100x at the time of acquisition. Two years later, the buyer settles the suit for $150x.

Under the close transaction approach, the seller would include $100x in amount realized at the time of the acquisition. When the buyer pays $150x two years later, the seller would report an additional $50x of amount realized from the sale.

Under the second approach, the seller would increase the amount realized only when the liability becomes fixed. Thus, in the example, the seller would not increase the amount realized until two years after the acquisition and would report income of $150.

b) **Deduction or Offset**

(1) Reg. §1.461-4(d)(5)

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246 Michael L. Schler, Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More, 43 Tax L. Rev. 605, 670-675 (1998); New York State Bar, "Treatment of 'Deferred Revenue' by the Buyer in Taxable Asset Acquisitions" (Tax Notes Today, January 8, 2013).
247 James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964).
249 This result may be the treatment preferred by the IRS since they generally favor closed transaction treatment for the seller. See, e.g., the Preamble to the proposed regulations under Code §338 released 8/10/99. The closed transaction approach for contingent liabilities is also consistent with the treatment of contingent consideration under §1001. Under Reg. §1.1001-1(g), the current fair market value of promised future contingent payments is taken into account in amount realized unless, in rare and extraordinary circumstances, the fair market value is not reasonably ascertainable.
In general, the seller's amount realized should be increased by the amount of the assumed liabilities.\(^{250}\) The result, in essence, is that the taxpayer has gain for which it has received no tax benefit, either in the form of a deduction or basis. This seemingly uneconomic result is ameliorated by Reg. §1.461-4(d)(5). Reg. §1.461-4(d)(5)(i) provides that “if, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See §1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.”\(^{251}\)

Thus, an accrual-method seller required to include in its amount realized the value of a liability will be entitled to an offsetting deduction, equal to the amount of the inclusion of a liability assumed by the buyer in the seller's amount realized, at the time the inclusion in the seller's amount realized occurs and in the amount of such inclusion, provided (1) the assumption occurs in connection with a taxable sale of all the assets used by the seller in the conduct of the trade or business in which the liability was incurred, (2) the seller would have been entitled to a deduction if the "economic performance" test had been satisfied by the seller with respect to the liability assumed prior to the sale, and (3) the "all events" test is satisfied at the time the liability is included in the seller's amount realized (i.e., the liability is fixed and determinable).\(^ {252}\)

(2) The Pierce Case

The leading case addressing the availability of a deduction or offset to the seller is *James M. Pierce Corporation v. Commissioner*.\(^ {253}\) In *Pierce*, a newspaper publishing company that accounted for income from paid subscriptions as the subscriptions were fulfilled—i.e., on a reserve method—sold its assets and liquidated. The buyer expressly assumed the liabilities of the company, including the unearned subscription liability. The court held that the seller must include in income the amount of the subscription reserve as a result of the buyer's assumption of the obligation to fulfill the subscriptions. Further, the court held that the inclusion in income was "in effect nullified by an offsetting deduction equal to the amount by which the gross sale price to [the taxpayer] was reduced by [the buyer's] assumption of the subscription liabilities." In this regard, the court stated:

> By [the buyer's] assumption of the obligations which those reserves represented, the taxpayer's cash received on the sale of the business was reduced. This is just as much an out-of-pocket payment by the taxpayer as if it had first received the gross amount from [the buyer] and then repaid [the buyer] cash equal to the amount of the reserves. It is just as much an out-of-pocket payment by the taxpayer as if, in fiscal 1957, it had used other available cash of its own and on its own initiative refunded the subscribers the amounts of their unearned or redeemable subscriptions. This either would constitute a deductible business expense under §162(a) or it would operate in reduction, and

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\(^{250}\) See, e.g., Reg. §§1.1001-2(a)(1) and (4)(i) and (iii). Under these provisions, in the case of a transfer of property to a buyer in which the buyer assumes a recourse obligation of the seller, the amount of the recourse obligation generally is included in the seller's amount realized for purposes of determining gain or loss under Code §1001, and in the case of property securing a nonrecourse obligation of the seller, the amount of the nonrecourse obligation securing the property generally is included in the seller's amount realized. See also Fisher v. Commissioner, 84 T.C. 1319 (1985), *aff'd* without opinion, 806 F.2d 263 (9th Cir. 1986); Pierce v. Commissioner, 326 F.2d 67 (8th Cir. 1964); Rev. Rul. 68-112; 1968-1 C.B. 62; Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981); Rev. Rul. 71-450, 1971-2 C.B. 78.

\(^{251}\) Compare Rev. Rul. 95-74, 1995-2 C.B. 36 (concluding that the transferee corporation in a Code §351 exchange steps into the shoes of the transferor with respect to assumed contingent environmental liabilities that arose out of the business in which the transferred assets were used).

\(^{252}\) 1994 FSA LEXIS 164 (Dec. 19, 1994) (Reg. §1.461-4(d)(5)(i) did not apply to assumed contingent liability as to which the all-events test was not met at the time of assumption).

\(^{253}\) 326 F.2d 67 (8th Cir. 1964).
here, by reason of identity of amounts, on elimination, of the income includable with the cessation of the need for the reserves. In either case, the result is the same.

The Pierce case appears to set forth two possible approaches regarding the treatment of the seller in the case of assumed liabilities. Under the first approach (1) the seller's amount realized is increased by the amount of the assumed liability; (2) followed by a deduction in an amount equal to the assumed liability (the "deduction approach"). Under the second approach, the assumed liability directly offsets any increase in the amount realized, resulting in no net increase (the "offset approach"). That is, the assumed liability constitutes a "deduction for gross income" rather than a "deduction from gross income." The primary difference between the deduction approach and the offset approach is that, with regard to the deduction approach, the statutory rules relating to the availability of a deduction, such as §162 or §404, would apply. In contrast, the ability to claim an offset against amount realized, either as an increase to cost of goods sold or as a decrease in amount realized itself, is not affected by such rules.

(3) Impact of Code §267

If a transaction is between related parties as defined in Code §267(b), Code §267 may apply to disallow or defer a deduction arising under Reg. §1.461-4(d)(5) and the rationale of the Pierce case. Specifically, there are three provisions of Code §267—Code §§267(a)(1), (a)(2), and (f)—that raise particular concern. Code §267 and the regulations thereunder should be carefully analyzed in making this determination.

(4) Deferred Compensation Issues

There is very limited guidance in the way of published positions of the Service or case law regarding the income tax consequences to the seller resulting from the assumption of deferred compensation liabilities, particularly nonqualified deferred compensation. Based on the general principles regarding assumed liabilities, one might expect that the seller's amount realized is increased by the assumed deferred compensation liabilities at the time of sale. However, based on the requirements of Code §404(a)(5), discussed in detail above, which defers any deduction for deferred compensation until the employee includes the compensation in income, any seller deduction under Reg. §1.461-4(d)(5) or Pierce is arguably deferred until such requirements are met.

There is one published position of the Service and one case addressing the seller's deduction for an assumed deferred compensation liability—TAM 8939002 and Sol Jacobs v. Commissioner. Significantly, neither of these address the impact of assumed deferred compensation liabilities on amount realized; however, both cases hold that a seller is not entitled to a deduction for the deferred compensation liability.

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254 This distinction between deductions from gross income (i.e., deductions) and deductions for gross income (i.e., offsets) has been recognized by the courts. See, e.g., Max Sobel Warehouse Liquors v. Commissioner, 69 TC 477 (1977), aff'd, 630 F.2d 670 (9th Cir. 1980) (the taxpayer, which was in the wholesale liquor business, made illegal, in-kind rebates to retail liquor customers; taxpayer could include the amounts of the illegal rebates in its cost of goods sold despite the fact that no deduction would have been permitted under §162(c)); Pittsburgh Milk Co. v. Commissioner, 26 TC 807 (1956) (illegal rebates to purchasers of milk represented adjustments to the sales price of milk and were not deductions from gross income); see also Estate of Viola Bray v. Commissioner, 46 T.C. 577 (1966), aff'd, 396 F.2d 452 (6th Cir. 1968) (offset of sales costs of securities in computing taxable income of an estate was proper even though they were also deducted under §2053 in computing the decedent's income despite §642(g), as in effect prior to 1976, which prohibited amounts deducted in computing the decedent's gross income from being deducted in computing the estate's income; an offset against selling price in determining the estate's gross income did not constitute a deduction prohibited by §642(g)).

255 See also Estate of Viola Bray v. Commissioner, 46 T.C. 577 (1966), aff'd, 396 F.2d 452 (6th Cir. 1968) (offset of sales costs of securities in computing taxable income of an estate was proper even though they were also deducted under §2053 in computing the decedent's income despite §642(g), as in effect prior to 1976, which prohibited amounts deducted in computing the decedent's gross income from being deducted in computing the estate's income; an offset against selling price in determining the estate's gross income did not constitute a deduction prohibited by §642(g)).

256 (7/15/1989).

257 45 T.C. 133 (1965).
liability until the requirements of Code §404(a) are met—that is, the deferred compensation is included in the employee's income.

In TAM 8939002, the taxpayer sold all of its assets in a taxable asset acquisition. In connection with the acquisition, the buyer assumed the seller's liability to pay deferred compensation under a nonqualified plan subject to Code §404(a)(5). The taxpayer argued that it was entitled to a deduction for the assumed deferred compensation liability, relying on the analysis in Pierce. The Service rejected the taxpayer's argument, distinguishing Pierce by stating that "§404(a) removes deductions for payments of deferred compensation from general tax accounting and deduction rules." As a result, the taxpayer was not allowed a deduction for the liability until it became deductible under Code §404. The IRS did not address, nor even mention, the treatment of the seller with regard to any income from the assumption of the deferred compensation obligation. It is important to note that TAM 89390002 was issued prior to the issuance of the economic performance regulations, including Reg. §1.461-4(d)(5), on April 10, 1992.

Similarly, in Sol Jacobs, an accrual basis corporate taxpayer agreed to pay a retiring employee a monthly amount until such payments totaled $10,000 or the retiree died, whichever occurred first. The corporation made ten such payments between the signing of the agreement and the date of its liquidation. Pursuant to the liquidation, the corporation's shareholders assumed the corporation's obligation under the agreement. In its final return, the corporation claimed a deduction for the actuarially computed value of the unpaid obligation. The Tax Court noted that the arrangement deferred the receipt of compensation and therefore clearly fell within the ambit of Code §404(a). Specifically, the Tax Court stated that Code §404(a) moves such deferred compensation arrangements from the normal rules of tax accounting, regardless of whether the taxpayer is on a cash, accrual, or other method of accounting. The Tax Court held that the present value of the obligation to make payments was not deductible by the corporation on its final income tax return, because payments of deferred compensation are deductible only when actually paid under Code §404(a)(5).

There may be several arguments against the timing mismatch resulting from the holdings in TAM 8939002 and Sol Jacobs—that is, as a result of these holdings, the seller would seem to be required to increase its amount realized in the year of the sale, but would not be entitled to any corresponding deduction in the year of sale. First, deferring the seller's deduction does not appear to promote the purposes underlying Code §404(a), whereas allowing the seller a deduction or offset at the time of sale does not violate the purposes underlying Code §404(a)(5). Second, clear reflection principles would appear to support allowing the seller a deduction or offset at the time of sale. Third, the economic performance regulations appear to support permitting the seller a deduction under Reg. §1.461-4(d)(5) for an assumed deferred compensation liability. Finally, to the extent that the assumed liability is viewed as an offset to amount realized under Pierce, there is an argument that Code §404(a)(5) is not implicated.

(a) Code §404(a)(5) Principles

Code §404(a)(5) provides that in a case of a nonqualified plan, any contributions made pursuant to the plan are deductible in the taxable year in which the amount attributable to the contribution is includible in the gross income of the employees participating in the plan. This requirement was enacted to insure the integrity of pension plans and to "guarantee the beneficiary the full advantage of any contribution which entitles the employer to a tax benefit."258

As discussed in detail above, it is well established that a buyer cannot obtain an increase in basis as a result of an assumed deferred compensation liability until the requirements of Code §404(a) are satisfied. This deferral is consistent with the statutory requirements of Code §404(a), because it precludes the buyer from obtaining a tax benefit from the assumed deferred compensation liability until it is actually paid. As specifically noted by the Seventh Circuit in Webb, the deferral of the buyer's basis until the deferred

258 See Webb, 77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983).
compensation is included in the employee's income is consistent with the policies underlying Code §404(a)—to prevent a mismatch between the employer and the employee.\textsuperscript{259}

Specifically, with regard to this policy, deferring the buyer's basis until the deferred compensation liability is included in the employee's income ensures that buyer will not receive a tax benefit from such compensation until the employee receives the benefit of the deferred compensation. On the other hand, immediately increasing the seller's amount realized while deferring the seller's deduction would not seem to promote the policy of ensuring that the employee receives the benefit of the deferred compensation.

After the sale, it is the buyer, not the seller, who is responsible for paying the compensation to the employee. The seller has no control over whether or when the employee is paid and may not even be in existence when the deferred compensation is paid. Consequently, deferring a tax benefit to the seller arguably does nothing to further the congressional objective of ensuring that employees, in fact, receive the compensation benefits to which they are entitled. Because the statutory requirements and the policies underlying Code §404(a) are met by deferring an increase in the buyer's tax basis in the acquired assets, it is arguably unnecessary also to defer a deduction to the seller.

Based on the foregoing, there is an argument under Code §404(a) principles for the position that the seller does not have to take into account in the year of the sale any increase in amount realized resulting from the assumption of a deferred compensation liability without a corresponding deduction or offset in the year of the sale, because such position (1) does not violate the statutory requirements of Code §404, since the buyer's basis in the acquired assets is deferred; and (2) serves to further the policy underlying Code §404 of guaranteeing the employee "the full advantage of any contribution which entitles the employer to a tax benefit."

\begin{itemize}
  \item [(b)] Clear Reflection of Income Principles
\end{itemize}

Clear reflection of income is an overriding principle of tax law. Clear reflection has been defined to mean that "income should be reflected with as much accuracy as standard methods of accounting practice permit."\textsuperscript{260} The goal of clear reflection is to prevent distortions of income to ensure that the proper amount of taxable income is reported.\textsuperscript{261} Code §446(b) requires that a taxpayer's method of accounting clearly reflect income and gives the Commissioner broad discretion to determine whether a method of accounting clearly reflects income. Clear reflection of income principles permeate all areas of tax law and have been applied to change the treatment of an item even though statutory requirements were otherwise met. For example, in \textit{Exxon Mobil Corp. v. Commissioner},\textsuperscript{262} the Tax Court denied a taxpayer's deductions for certain liabilities otherwise satisfying the all-events test under Code §461, stating that allowance of deductions for those liabilities in the year claimed would have distorted the income of that year. The use

\textsuperscript{259} In this regard, the Seventh Circuit in \textit{Webb} stated:

\begin{quote}
[T]he taxpayer concludes that assumed pension obligations cannot be used to increase the cost basis of acquired assets because that would allow taxpayers to gain through depreciation a tax benefit before actual pension payments are made. This argument, however, ignores the Tax Court's holding that the taxpayer may increase the cost basis of acquired property only when pension payments are actually made, not when the obligation was merely assumed. The Tax Court's decision, therefore, is totally consistent with the policy behind §404(a).
\end{quote}

\textsuperscript{260} Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953).

\textsuperscript{261} See, e.g., Exxon Mobil Corp. v. Commissioner, 114 T.C. No. 20 (2000) (where the court denied deductions for certain liabilities otherwise satisfying the applicable all-events test, stating that allowance of deductions for those liabilities in the year claimed would have distorted the income of that year); Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970) (where deductions were disallowed, because they distorted income where they would not be paid for 15, 20, or even 30 years); Ford Motor Co. v. Commissioner, 102 T.C. 87 (1994), aff'd, 71 F.3d 209 (6th Cir. 1995) (where the taxpayer was denied a full deduction for certain fixed obligations, because of, among other reasons, the distortion resulting from the substantial delay between the timing of the deduction and the actual payment of the liabilities involved).

\textsuperscript{262} 114 T.C. No. 20 (2000).
of the clear reflection standard to depart from what is understood as the clear requirements of applicable Code sections and Treasury regulations also works in favor of the taxpayer.263

Despite the clear mandate of Code §461(h) that liabilities cannot be taken into account until they are economically performed, the Service and Treasury promulgated Reg. §1.461-4(d)(5), which, based on clear reflection principles, allows the seller to take into account assumed fixed and determinable liabilities prior to the time economic performance is met. In the preamble to the notice issuing the regulations (the "Preamble"), the Service states:

One commentator recommended that a similar rule be provided in the case of service and property liabilities expressly assumed by the purchaser of the taxpayer's trade or business and properly included in the amount realized from the sale. Acceleration of economic performance in the case of the sale or exchange of an entire trade or business is proper because these sales are often followed by liquidations of the selling entity. In these cases, but for an acceleration of economic performance, the seller would be precluded from taking into account the liability. Therefore, the regulations adopt this suggestion.

Commentators also recommended that §1.461-4(g)(1)(ii)(C) be applied to liabilities that are assumed in connection with a sale or exchange of assets representing less than the entire trade or business where the seller is required to include the assumed liabilities in income. A sale or exchange of these business assets does not present the same liquidation concerns that arise in the context of a sale of an entire trade or business. The Service and the Treasury Department believe that adopting this recommendation could significantly undermine the principles of economic performance by allowing taxpayers to accelerate some business deductions while continuing to own the business. Consequently, the final regulations do not adopt the commentators' recommendation.

Significantly, Reg. §1.461-4(d)(5) demonstrates the broad reach of clear reflection principles to achieve a result different from a statute in order to prevent distortions in income. In other words, the Service specifically recognized that, in connection with the sale of a trade or business, if the seller is not allowed a deduction for assumed liabilities, it may never be able to take such a deduction because the seller is often liquidated either immediately after the sale or later, which results in an improper amount of income tax being paid over the life of the taxpayer. Further, clear reflection may be difficult to achieve when the payment or performance of an assumed liability is in control of the buyer, rather than the seller, and the seller may never be notified when payment or performance occurs. In addition, it is worth noting that the Preamble does not distinguish between liquidations under Code §331 or §332. The concerns regarding distortion of income are present in either scenario. Therefore, in order to ameliorate any distortions in income, Reg. §1.461-4(d)(5) permits the seller to deduct an assumed liability by deeming economic performance to occur.

Based on the foregoing, clear reflection principles permeate all areas of the tax law. In the area of assumed fixed and determinable liabilities, clear reflection principles may support an argument that a seller be allowed to reduce the increase in the amount realized by the amount of the assumed liability. Further, clear reflection principles support a position that such reduction occur at the time of the sale, because the seller may eventually liquidate and, therefore, be precluded from ever obtaining a deduction. Further, economic performance of the liability is within the control of the buyer, and the seller may have no way of determining if and when the liability is economically performed. In the case of deferred compensation liability under Code §404(a), clear reflection principles arguably support a position that the seller's amount realized is not increased in the year of the sale as result of the assumed deferred compensation liabilities without a corresponding deduction or offset.

(c) Impact of Economic Performance Regulations

The economic performance regulations set forth in Reg. §1.461-4(d) provide special rules for deferred compensation liabilities. Reg. §1.461-4(d)(2)(iii) provides that "[e]xcept as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under §404 ... 264

Similarly, in the Preamble to the economic performance regulations, the Service and the Treasury Department ("Treasury") stated with regard to deferred compensation liabilities that they believe "the specific timing rules contained in §404, §404A, and §419 generally should take precedence over the more general economic performance rules."

As noted above, the requirements of Code §404 generally control the timing of economic performance rules with regard to deferred compensation liabilities—i.e., the two requirements occur at the same time, which is when the Code §404 requirements are met. Further, as noted earlier, the economic performance rules under Reg. §1.461-4(d)(2)(iii) provide "[e]xcept as otherwise provided in any Internal Revenue regulations, revenue procedures, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under §404." Based on the language of Reg. §1.461-4(d)(2)(iii), the rules set forth in Reg. § 1.461-4(d)(5) arguably take precedence over both Code §404 and Reg. §1.461-4(d)(2)(iii). Specifically, Reg. §1.461-4(d)(2)(iii) applies only "[e]xcept as otherwise provided in any Internal Revenue regulations, revenue procedures, or revenue ruling." Reg. §1.461-4(d)(5) falls within the reference to "[e]xcept as otherwise provided." Therefore, in the case of the acquisition of a trade or business, arguably the rules of Reg. §1.461-4(d)(5), rather than Code §404 and Reg. §1.461-4(d)(2)(iii), apply to determine the tax consequences to the seller. Thus, in a sale or nonsale context, economic performance occurs at the same time the Code §404 requirements are met.

(d) Treating the Assumed Deferred Liability as an Offset

As discussed above, Pierce may provide authority for treating assumed liabilities as an offset to the amount realized. That is, the assumed liabilities are a direct offset against amount realized, thereby resulting in no net increase in the amount realized at the time of sale. As an offset, arguably the rules under Code §404 relating to the deductibility of a deferred compensation liability would not apply. First, as discussed above, several courts have recognized the distinction between deductions from gross income (i.e., deductions) and deductions for gross income (i.e., offsets). 265 Second, some courts have taken the position that any limitations on the ability to take a deduction, such as Code §162(c) (relating to the deductibility of illegal bribes, kickbacks, etc.), do not apply to deductions for gross income. 266 Based on these authorities, if the deferred compensation liability is treated as an offset against the sales proceeds, the requirements of Code §404 arguably would not apply.

Further, in the case of an offset of assumed deferred compensation liabilities against amount realized, it may be argued that the results achieved by an offset approach are consistent with clear reflection principles and do not violate either the statutory requirements of Code §404(a) or its underlying policies, since there is deferral on the buyer's side.

c) Application of Code §453

264 See also Reg. §1.461-1(a)(2)(iii)(D).
265 See, e.g., Max Sobel Warehouse Liquors v. Commissioner, 69 TC 477 (1977), aff'd, 630 F.2d 670 (9th Cir. 1980) (the taxpayer, which was in the wholesale liquor business, made illegal, in-kind rebates to retail liquor customers; taxpayer could include the amounts of the illegal rebates in its cost of goods sold despite the fact that no deduction would have been permitted under Code §162); Pittsburgh Milk Co. v. Commissioner, 26 TC 707 (1956) (illegal rebates to purchasers of milk represented adjustments to the sales price of milk and were not deductions from gross income).
266 Id.
Does the assumption by the buyer of a contingent liability effectively convert a Code §1060 transaction into an installment sale? For example, assume that Seller sells all of its assets to Buyer in exchange for cash and Buyer's assumption of Seller's contingent obligation to Z. When the Buyer makes payment to Z, the rules of Code §453 are arguably invoked, with additional income to the Seller.\textsuperscript{267} There does not appear to be any activity on the Service's part in this area, perhaps because of the complexities involved.\textsuperscript{268}

\textbf{(1) Contingent Payment -Installment Sales}

Pursuant to Code §453(a), income from an "installment sale" is taken into account under the "installment method." An "installment sale" is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.\textsuperscript{269} Installment sales include "contingent payment sales," which are sales of property for which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs.\textsuperscript{270} If a transaction qualifies for installment reporting, the provisions of Code §453 apply automatically, unless an affirmative election out of Code §453 is made.\textsuperscript{271}

As noted above, the installment method applies to contingent payment sales. The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or fixed payment terms.\textsuperscript{272} Regulations provide special rules for purposes of determining gain in contingent payment sales and for allocating the seller's basis to payments received and to be received.\textsuperscript{273} Rules are prescribed for three different contingent sale situations: (i) sales for which a maximum selling price is determinable; (ii) sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable;\textsuperscript{274} and (iii) sales for which neither a maximum selling price nor a definite payment term is determinable.\textsuperscript{275} A contingent payment sale is treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that can be received by the seller can be determined by the end of the year in which the sale or disposition occurs.\textsuperscript{276} If a contingent payment sale has a maximum stated selling price, the seller's gain on the sale is determined by treating the stated maximum selling price as the selling price, and the seller's basis is recovered ratably as each payment is received.

\textbf{(2) Code §453A Interest Limitation on Contingent Payments}

Code §453A imposes a limit on the deferral benefits provided by installment reporting. Specifically, Code §453A imposes an annual interest charge on the portion of the seller's tax liability deferred by the installment method. Specifically, the interest charge imposed by Code §453A(a)(1) applies to any nondealer installment obligation in excess of $150,000 that arose during the taxable year and remains outstanding at the close of the taxable year if the face amount of all such obligations that arose from sales

\textsuperscript{267} See Reg. §15A.453-1(c).
\textsuperscript{268} See, e.g., Code §453A (applying an interest charge to the federal income tax deferred by the installment sale reporting); Reg. §15A.453-1(c)(4) (applying complex rules to cases in which there is neither a stated maximum selling price nor a fixed period over which payments are to be received; these rules spread the seller's total basis in assets over 15 years, resulting in the front-loading of income in the year of sale and a deferral of the loss by as long as 15 years).
\textsuperscript{269} Code Section 453(b)(1).
\textsuperscript{270} Id. Reg. §15A.453-1(c)(1).
\textsuperscript{271} See Code §453(d). The rules electing out of Code §453 are set forth in Reg. §15A.453-1(d).
\textsuperscript{272} Treas. Reg. §15A.453-1(c)(1).
\textsuperscript{273} Treas. Reg. §15A.453-1(c)(2).
\textsuperscript{274} Treas. Reg. §15A.453-1(c)(3).
\textsuperscript{275} Treas. Reg. §15A.453-1(c)(1).
\textsuperscript{276} Treas. Reg. §15A.453-1(c)(2)(i)(A).
during the year and remain outstanding as of the close of such taxable year exceeds $5,000,000. If interest
is required to be paid with respect to an obligation that arises during any year, interest must be paid for
any subsequent taxable year at the close of which any part of that obligation remains outstanding.

The determination of the interest required to be paid under Code §453A in a contingent payment sale is
unclear. As noted above, a prerequisite to the interest charge rules is that the face amount of the
installment obligation outstanding, as of the end of year, exceeds $5,000,000. Where the installment
obligation is a contingent payment obligation the face amount of the obligation is unclear. Further,
because the interest payable on the deferred tax liability must be based upon the "deferred tax liability"
with respect to the obligation as of the close of a tax year, which, in turn, will depend upon the amount of
the obligation's remaining unrecognized gain, it is unclear how these amounts are determined where the
payments are contingent. Code §453A(c)(6) provides that the Secretary shall prescribe regulations as may
be necessary to carry out the provisions Code §453A(c), including regulations providing for the
application of this subsection in the case of contingent payments, short taxable years and pass-through
entities. However, regulations have not been proposed or promulgated, notwithstanding the passage of 24
years.

It might be possible to argue that the provisions of Code §453A are not operative with respect to
contingent payment sales until regulations are issued. The courts and the IRS have held that a statute is
not self-executing where the Secretary was directed to regulations "as may be necessary to carry out the
provisions." However, the weight of authority appears to take the position that statutes which "direct
the Secretary to issue regulations as may be necessary to carry out the provisions" are self-executing in
the absence regulations.278

The IRS appears to take the position that Code §453A is self-executing with regard to contingent payment
sales.279 Assuming that Code §453A does apply to contingent obligations, it is unclear what approach
taxpayers should take in calculating the amount of interest to be paid on a contingent payment obligation.
In general, where there is a lack of statutory or regulatory guidance, or where the language is ambiguous,
a reasonable interpretation by a taxpayer has been upheld by the courts.280 The IRS as well as
collectors have set forth several approaches for applying Code §453A to contingent payments:281 (i)

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277 Hillman v. Commissioner, 263 F.3d 338 (4th Cir. 2001), rev'g 114 T.C. 103 (2000) (the Fourth Circuit reversed the Tax
Court's holding that Code §469(i)(2), which provides that "[t]he Secretary shall prescribe such regulations as may be
necessary or appropriate to carry out the provisions of [Section 469], including regulations ... was self-executing"); IRS
TAM 9714002 (the IRS held that Code §1504(a)(5)(F) was not self-executing in the absence of regulations).

278 See, e.g., International Multifoods v. Commissioner, 108 T.C. 579 (1997) (The Tax Court held that Code §865(j)(1),
which provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the
purpose of this Section, including regulations relating to the treatment of losses from sales of personal property", was self-
executing); Estate of Neumann v. Commissioner, 106 T.C. 216 (1996) (holding that Code §2663, which provides that "the
Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of [the GST tax],
including-- ... (2) regulations (consistent with the principles of [the estate and gift tax]) providing for the application of
[the GST tax] in the case of transferors who are nonresidents not citizens of the United States" was self-executing). See also
New York State Bar Association Tax Section, Report on Legislative Grants of Regulatory Authority (Nov. 3, 2006),
available on LEXIS at 2006 TNT 215-22; Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax
Lawyer 413 (2003); Crnkovich & Heller, "To the Extent" Provisions: When Do They Operate Without Regulations?, 76 J.

279 See, e.g., FSA 199941001; CCA 201121020.

280 See, e.g., Gottesman v. Commissioner, 77 T.C. 1149 (1981). See also, CCA 201121020 (a the absence of regulations
under Treas. Reg. §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).

281 The face amount of the contingent payment obligations and the amount of deferred gain would be determined based
on the value of any remaining contingent payments. Because a seller who elects out of installment reporting determines gain
in the year of sale using the fair market value of the contingent payment obligation, it is reasonable to conclude that
"deferred tax liability" for interest charge purposes should also be based upon the obligation's fair market value as of the
close of any tax year (see also, Section 453(f)(8); American Bar Association, Tax Section, Comments Regarding
Regulations to be Promulgated Under Section 453A (March 1, 1991) ("ABA Comments")), However, a fundamental
the value of the contingent payments\textsuperscript{282}, (ii) the stated maximum selling price,\textsuperscript{283} and (iii) the amounts actually paid.\textsuperscript{284}

C. Code §338

The Code §338 regulations that were issued in 2001 incorporate the Service's position that (1) with respect to the seller, contingent liabilities should be included in the amount realized pursuant to general tax principles; and (2) with respect to the buyer, that basis cannot be taken until economic performance has occurred. Thus the rules are virtually identical to those applicable to Code §1060 transactions.

1. Treatment of Buyer under Code §338

The final Code §338 regulations provide that in order to be taken into account in calculating buyer's basis, a liability of target must be a liability that is properly taken into account in basis under general principles of tax law. Thus, the final regulations have adopted the Code §1060 approach.

2. Treatment of Seller under Code §338

The final regulations provide that the amount of the sale price includes liabilities to the extent they would be included under general principles of tax law. That is, the regulations appear to adopt the "closed transaction" approach similar to Code §1060. The Service informally indicated that a seller must value a contingent liability, under general tax principles, when possible and the transaction must be "closed." This interpretation would seem to be based on the general rule in former Reg. §1.338(b)-3T(a)(1), which states that subsequent adjustments are made to the amount realized and basis only when required under general tax principles.

Once the liability is taken into income, the seller presumably would then be entitled to deduct the amount of the liability, provided it would have been otherwise deductible.\textsuperscript{285} This was not always the case. In IRS TAM 8741001,\textsuperscript{286} discussed above, the Service concluded that the seller in a §338 deemed asset sale was required to adjust sales proceeds to add the amount of a contingent liability when the contingent liability became fixed, but did not allow the seller a corresponding deduction because the seller was not in problem with this approach is the difficulty inherent in determining the fair market value of the contingent payments. The contingent payment sales set forth in Treas. Reg. §15a.453-1(c)(2) avoid requiring taxpayers to value contingent payment obligations.

\textsuperscript{282} The face amount of the contingent payment obligations and the amount of deferred gain would be determined based on the value of any remaining contingent payments. Because a seller who elects out of installment reporting determines gain in the year of sale using the fair market value of the contingent payment obligation, it is reasonable to conclude that "deferred tax liability" for interest charge purposes should also be based upon the obligation's fair market value as of the close of any tax year (see also, Section 453(f)(8); American Bar Association, Tax Section, Comments Regarding Regulations to be Promulgated Under Section 453A (March 1, 1991) ("ABA Comments"). However, a fundamental problem with this approach is the difficulty inherent in determining the fair market value of the contingent payments. The contingent payment sales set forth in Treas. Reg. §15a.453-1(c)(2) avoid requiring taxpayers to value contingent payment obligations.

\textsuperscript{283} If the contingent payment obligation has a stated maximum price, the Code §453A interest charge could be computed using the stated maximum amount. CCA 201121020 (stating that a reasonable approach would be to use the methods for calculating interest on contingent payment sales under Treas. Reg. §15a.453-1(c)(2)); IRS NSAR 20080101F (2007); see the ABA Comments, supra. There are risks that the taxpayer would have overpaid the interest if the amount of the payments turns out to be less than the stated maximum amount. The IRS has held that any amount of interest overpayments in closed years cannot be refunded (IRS Letter Ruling 9853002).

\textsuperscript{284} See CCA 201121020; IRS NSAR 20080101F and ABA Comments, supra. Under this approach, the first $5 million of payments received after the year of sale is excepted from the application of §453A(c). All payments received in the year(s) subsequent to the year of sale in excess of $5 million, in aggregate, are subject to the interest charged (CCA 201121020). The IRS has recognized that this approach avoids the risk that refunds of interest overpayments in closed years are lost (IRS NSAR 20080101F).

\textsuperscript{285} See, e.g., Pierce, 326 F.2d 67 (8th Cir. 1964); Commercial Security Bank, 77 T.C. 145 (1981).

\textsuperscript{286} (6/16/87).
existence in the year the liability became fixed. The Service reversed this conclusion in IRS TAM 9125001, by allowing Old Target the offsetting deduction.

Example 2 of Reg. §1.338-5(b)(2)(iii) in the final regulations also supports an offsetting deduction by the seller. With regard to the treatment of Seller, compare Reg. §1.461-4(d)(5), which provides that economic performance occurs for old T as the amount of the liability is properly taken into account in amount realized on the deemed asset sale. Thus, the selling price is not redetermined when new T satisfies the economic performance requirements. Note that the result is that Seller (Old Target) takes a deduction in Year 1 and increases the amount of sales price in Year 1 by the amount of the liability. Buyer gets a basis adjustment in a later year when the liability is economically performed.

3. Basis Allocation

Once the buyer determines that a contingent liability may be reflected in basis, the amount of the liability must be allocated to the acquired assets. The regulations under Code §§338 and 1060 contain similar requirements for allocating purchase price among the assets acquired, known as the residual allocation method. Certain issues may arise when contingent liabilities are not immediately reflected in the buyer’s basis upon acquisition (i.e., when economic performance occurs at a later date). Additionally, careful consideration should be given when indemnification agreements are in place as such agreements could cause complexities in determining how contingent liabilities are recognized by each of the parties.

D. Code §351 Transfers

Contingent liabilities may be assumed upon the incorporation of a business under Code §351. Code §351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation provided that, immediately after the exchange, such person or persons are in control of the corporation to which the property is transferred.

1. Tax Effect to Transferor

From the transferor’s perspective, Code §§357(c) and (d) and Code §358(h) are the primary provisions that may apply if contingent liabilities are assumed.

If liabilities are assumed in a Code §351 transaction, Code §357(a) provides that the assumption of a liability by the transferee corporation generally does not cause the transferor to recognize gain. As an exception to Code §357(a), Code §357(c)(1) provides that the transferor recognizes gain to the extent the transferee assumes liabilities of the transferor in excess of the aggregate basis of the transferred assets. Code §357(c)(3) sets forth an exception from the liabilities in excess of basis rule in Code §357(c)(1) for liabilities that give rise to a deduction when paid. Although Code §357(c)(3) is typically viewed as applying to liabilities of cash basis transferors, it can also apply to contingent liabilities of accrual basis transferors.

287 (12/24/90).

288 See Hamilton Industries v. Commissioner, 97 T.C. 120 (1991) dealing with false bargain purchases resulting from contingent liabilities; see also of Arrowsmith v. Commissioner, 344 U.S. 6 (1952) dealing with treatment of contingent liabilities allocable to assets sold and the classification of the loss as ordinary vs. capital.

289 The American Jobs Creation Act of 2004 amended Code §357(c) by limiting its applicability to transfers to which Code §351 applies and divisive D reorganizations. Thus, Code §357(c) no longer applies to acquisitive D reorganizations. However, issues have arisen with respect to the scope of Code §357(c) where a transfer constitutes both a Code §351 transfer, as well as an acquisitive D reorganization. The 2006-2007 Priority Guidance Plan issued by the IRS in 8/06 indicates that the IRS plans on issuing guidance regarding the applicability of Code §357(c) to transactions that qualify as both Code §351 transfers and acquisitive D reorganizations.

290 In the consolidated group context, the Service has issued proposed regulations under Reg. §1.1502-80 (to be applied prospectively) that set forth special rules for the application of Code §357(c) to Code §351 transactions within a consolidated group. The proposed regulations attempt to eliminate a concern that current Reg. §1.1502-80(d) may require duplicated basis reductions (under Code §358(d) at the time of the contribution and Reg. §1.1502-32 at the time of the
Code §357(d) sets forth specific rules for determining when recourse and nonrecourse liabilities are treated as assumed for purposes of Code §357. Under Code §357(d)(1)(A), a recourse liability (or portion thereof) is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy the liability (or portion), regardless of whether the transferor is relieved of a liability. Under Code §357(d)(1)(B), a nonrecourse liability is treated as assumed by the transferee of any asset subject to the liability. Code §357(d)(2) sets forth an exception to the general nonrecourse liability that may reduce the amount treated as assumed; however, the exception leaves open the possibility that the amount treated as assumed will not be reduced if there is no agreement between the transferor and transferee. The IRS is concerned that this potential result does not reflect the economics of the transaction. The IRS and Treasury are seeking comments on ways to resolve this issue and are expected to promulgate proposed regulations in the near future.

With respect to Code §357(c) and (d), it is unclear whether a contingent liability constitutes a liability for purposes of those statutory provisions. One could surely argue that a contingent liability should not be taken into account until the fact of liability is established. However, to the extent the liability may be valued, given the Service's preference for a "closed transaction," it may be argued that the liability would be taken into account on the date of the transaction (up to its value). In such case, one may still argue that Code §357(c)(3) would apply (which excludes from Code §357(c) liabilities the payment of which would give rise to a deduction). But, note that it is unclear what impact, if any, Code §461(h) (or Code §404) may have on the application of Code §357(c).

On the other hand, one place where contingent liabilities clearly must be taken into account with respect to exchanges subject to Code §358 is in Code §358(h). Code §358(h) was enacted to limit the transferor's basis in the transferee stock received in a Code §351 exchange. Specifically, under Code §358(h)(1), if the basis of stock received as part of a tax-free exchange exceeds its FMV, then the stock basis is reduced (but not below its FMV) by the amount of any liability that (1) is assumed in the exchange for such stock and (2) did not reduce the transferor's basis of the stock by reason of the assumption of the liability under Code §358(d)(1). Code §358(h)(3) specifically includes contingent liabilities within the scope of this rule. If, however, the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, the general rule of Code §358(h)(1) does not apply and the basis of the stock received in the exchange is not subject to reduction.

2. Tax Effect to Transferee

The main issues here are: (1) whether the transferee is entitled to a deduction upon payment of the contingent liability; and if not, (2) what effect, if any, results from the transfer of the liability. It would seem that the transferee would be entitled to a deduction (if the transferor would otherwise have been entitled to a deduction).


293 Code §358(h)(2)(B) provides another exception to the general rule of Code §358(h)(1) if, as part of the exchange, substantially all of the assets with which the liability is associated are transferred to the person assuming the liability. This exception was removed, however, by temporary regulations under Code §358(h) for transactions occurring on or after 6/24/03. The IRS and Treasury finalized these regulations, effective for transactions occurring on or after 5/9/08. See Reg. §1.358-5.
The leading case, however, addressing the treatment of contingent liabilities in a Code §351 context is *Holdcroft Transportation v. Commissioner.* In *Holdcroft*, a partnership was incorporated, and the transferee taxpayer assumed the liabilities of the partnership, including two tort claims. The court held that the taxpayer's subsequent payment of the claims was not deductible, because the claims were attributable to the operation of the partnership. The court noted that the taxpayer does not step into the shoes of the partnership with respect to the payments. Payment of the claims is a cost of acquiring the partnership business, and the fact that the claims against the partnership were contingent and unliquidated at the time of acquisition is not of a controlling consequence.

In *Rev. Rul. 95-74*, the Service considered *Holdcroft* and arrived at a contrary result. In that ruling, the Service first addressed whether such contingent liabilities are taken into account under Code §§357(c) and 358. Second, the ruling addressed whether the transferee may take a deduction upon satisfying the contingent liability.

The facts of the ruling were that in Year 1, a company, P, transferred its manufacturing business to a newly formed corporation, S, in exchange for all of S's stock and S's assumption of the manufacturing business's liabilities, which included contingent environmental liabilities. The land was not contaminated by any hazardous waste when P purchased it. However, as a result of plant operations, certain environmental liabilities are now associated with the land. In Year 3, S undertook remedial efforts relating to the transferred land and incurred costs (within the meaning of Code §461(h)) as a result of those efforts. Of the total amount of costs incurred, a portion would have constituted ordinary and necessary business expenses that are deductible under Code §162 and the remaining portion would have constituted capital expenditures under Code §263 if there had not been a Code §351 exchange and if P had directly incurred the remediation effort costs.

The ruling held that under Code §357(c)(1), the contingent environmental liabilities were not included in determining whether the amount of liabilities assumed by S exceeded the adjusted basis of the property transferred by P. The ruling based this conclusion on the fact that P, prior to the transfer, had not yet taken the contingent environmental liabilities into account. Thus, the ruling treated the contingent liabilities as any other liability (i.e., fixed liability) that is excluded from the Code §357(c)(1) calculation pursuant to Code §357(c)(3) (i.e., where the liability would give rise to a deduction or capital expenditure). In addition, because such liabilities were not included in the determination under Code §357(c)(1), the liabilities were not included in the Code §358 determination of the transferor's basis in the stock received in the Code §351 exchange due to the parallel construction of Code §§357 and 358.

Regarding S's deductibility of payments, the Service held that it will not follow the decision in *Holdcroft*. Instead, *Rev. Rul. 95-74* held that because the costs S incurred to remediate the land otherwise would have been deductible in part and capitalized in part by P, the Congressional intent to facilitate necessary business readjustments would be frustrated by not according to S the ability to deduct or capitalize the expenses of the ongoing business. The ruling cited the legislative history of Code §351, which indicates that Congress viewed an incorporation as a mere change in the form of the underlying business and enacted Code §351 to facilitate such business adjustments generally by allowing taxpayers to incorporate businesses without recognizing gain.

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294 153 F.2d 323 (8th Cir. 1946).
295 See also M. Buten & Sons v. Commissioner, 31 T.C.M. 178 (death benefits payable to widow of employee of predecessor partnership must be capitalized).
Holdcroft should also be contrasted with Rev. Rul. 83-155. There, a successor corporation of a partnership continued to make payments to a retired partner (or spouse of a partner) pursuant to a partnership agreement. The ruling held that payments made by the successor corporation were deductible by the corporation as ordinary and necessary business expenses. Rev. Rul. 83-155 stated that Congressional intent to facilitate necessary business readjustments would be frustrated by not according to the transferee the right to deduct expenses of the ongoing business which, if not assumed by the transferee, would have been deductible by the transferor.

Thus, Rev. Rul. 95-74 and Rev. Rul. 83-155 strongly suggest that the transferee corporation in a Code §351 context "steps into the shoes" of the transferor corporation. In addition, particularly in light of Rev. Rul. 95-74, Holdcroft's vitality appears to have been diminished and contingent liabilities assumed by a transferee corporation generally should be deductible if those liabilities would have been deductible by the transferor. IRS Letter Ruling 9343011 seems to support this view. If a deduction were disallowed, it would seem that the transferee should be entitled to basis as a result of the assumption. Code §362, however, provides for basis only to the extent that gain is recognized by the transferor. Note that a harsh and economically unsupportable result could occur where no deduction is allowed under Holdcroft and no basis is allowed under Code §362, because no gain is recognized by the transferor.

H.R. 2488, the Taxpayer Refund and Relief Act of 1999, which was vetoed by President Clinton, would have expanded the reach of the anti-abuse rule set forth in Code §357(b). The proposal would have amended Code §357(b)(1) to treat transactions where the arrangement for the assumption of liabilities was made for "a" principal purpose of tax avoidance rather than "the" principal purpose. This legislation would not have affected the validity of Rev. Rul. 95-74, since in that case, the taxpayer transferred the entire business along with the contingent liabilities and there was no evidence of tax avoidance. The proposed legislation was intended to address situations where contingent liabilities are transferred to newly formed corporations without the rest of the operating business to accelerate the deduction of contingent liabilities through the subsequent sale of such corporation's stock. Despite the president's veto, it is suspected that a modified version of the proposal will appear in some form of future legislation.

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299 See also Rev. Rul. 80-198, 1980-2 C.B. 113 (The Service ruled that a transferee corporation's assumption of certain trade accounts payable in connection with a Code §351 exchange and which would have given rise to a deduction had the transferor paid the trade accounts payable, will be allowed as deductions under Code §162 to the transferee corporation for payments it makes to satisfy the assumed trade accounts payable when such payments are made); IRS CCA 201023056 (9/22/09)(citing Rev. Rul. 95-74 and Rev. Rul. 80-198, in a transaction that qualified either as a Code §351 exchange or Code §368(a)(1)(D) reorganization, the Service ruled that the transferee corporation's assumption of a settlement payment related to a class action suit brought against the transferor corporation and which would have given rise to a deduction had the transferor made the settlement payment, was allowable as a deduction to the transferee corporation).
300 (7/16/93).