

Contingent Purchase Price in Taxable Acquisitions

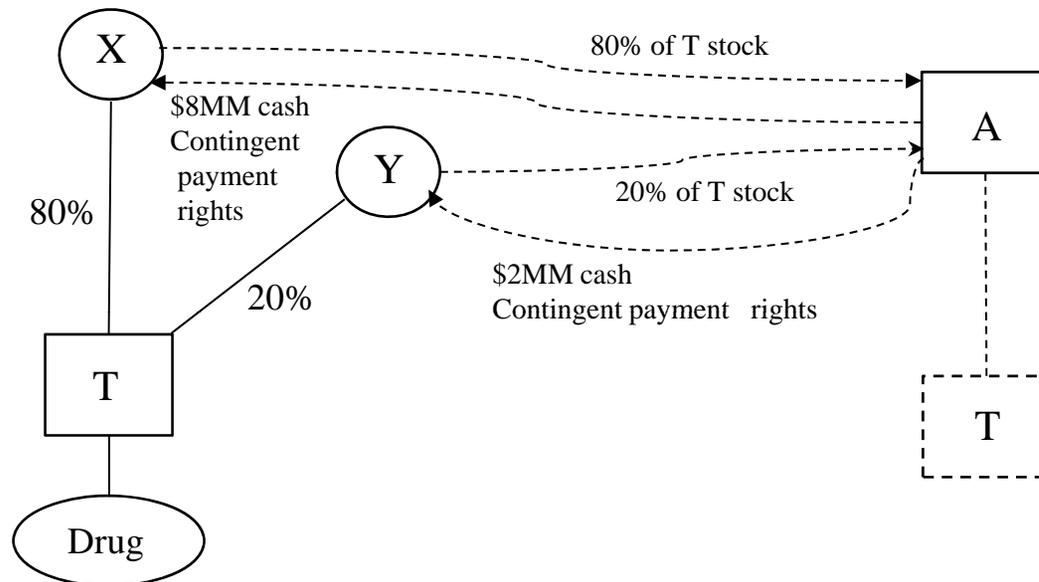
Contingent Purchase Price in Taxable Acquisitions Seller Consequences

- Closed transaction method
- Open transaction method
- Installment method

Contingent Purchase Price in Taxable Acquisitions

Seller Consequences

Discussion Problem—Facts



- X has owned 80%, and Y has owned 20%, of the T stock for five years. X's and Y's stock basis = \$0
- T has developed Drug that could cure a dreaded disease, but no clinical trials leading to regulatory approval have been held
- X and Y sell the T stock to P for:
 - \$10 million cash
 - Right to payments up to \$100 million as regulatory milestones are reached
 - Right to percentage of sales of Drug with no maximum
- In its financial statement, A reports a \$25 million liability for the contingent payments to X and Y

Contingent Purchase Price in Taxable Acquisitions

Seller Consequences

Discussion Problem

Analysis

- **Closed transaction**
 - Gain taxed at closing = cash received + FMV of contingent payment right
A's gain = \$8MM + \$20MM (?). All long-term capital gain
B's gain = \$2MM + \$5MM (?). All long-term capital gain
 - Gain or loss on contingent payments
 - Recovery of basis up to FMV taxed at closing
 - Gain to extent contingent payments received > FMV taxed at closing — probably ordinary income
 - Loss to extent payments received < FMV taxed at closing — probably ordinary loss
 - Imputed interest taxed as ordinary income as cash received
- **Open transaction**
 - Gain taxed at closing = cash received; all long-term capital gain
 - Gain on contingent payments taxed as received; all long-term capital gain except imputed interest
- **Installment method**
 - Gain taxed at closing = cash received; all long-term capital gain
 - Gain on contingent payments taxed as received; all long-term capital gain except imputed interest
 - Section 453A deferral charge on deferred gain >\$5MM
 - How is “deferred gain” determined?
- *See also* §1202

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Treatment at Closing

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Gain or Loss on Receipt of Contingent Payment

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Character of Gain or Loss
Debt Instrument or Contract Right?

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

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

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
FMV of Contingent Payment Rights Underestimated
Character of Gain

- What happens if little is expected but much is received from contingent payment right?
- Possible conversion of contingent sale price from capital gain to ordinary income
 - Contingent payment right is determined to be contract right, not debt instrument
 - *Arrowsmith v. Commissioner*, 344 U.S. 900 (1952) does not govern

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
FMV of Contingent Payment Rights Overestimated
Character of Loss

- What happens if much is expected but little or nothing is received from the contingent payment right?
- If gain from an underestimated FMV of contingent payment right would be ordinary income, loss from overestimated FMV should be ordinary loss
- If the loss is a capital loss, the loss can be orphaned if capital gains are not available:
 - Gain recognized on the sale may not be available from loss carryback
 - If Seller is an individual, no carryback
 - If Seller is a C corporation, 3-year carryback

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Open Transaction Method
General

- Based on *Burnet v. Logan*, 283 U.S. 404 (1931); *see also Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq.* 1948-1 C.B. 2
- Available only in “rare and extraordinary” cases where FMV of contingent payment right is not reasonably ascertainable (Reg. §1.1001-2(g)(2)(ii))
- Compare *Dorsey v. Commissioner*, 49 T.C. 606 (1968) and *MacDonald v. Commissioner*, 55 T.C. 840 (1971) (open transaction method allowed) with *In re Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (open transaction method partially allowed)

Contingent Purchase Price in Taxable Acquisition
Seller Consequences
Open Transaction Method
Comparison with Other Methods

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Open Transaction Method
Recent Support

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

Contingent Purchase Price in Taxable Acquisitions

Seller Consequences

Installment Sale

General

- Defers tax on gain from future payments until received
- Applies only to gain, not loss
- General rule is *pro rata* basis recovery
- If there is a maximum selling price, recover basis on assumption that maximum price will be received
- If there is no maximum selling price, but there is a time limitation, recover basis straight-line over maximum time for payments
- If there is neither maximum selling price nor time limitation—
 - o Basis recovery is straight-line over 15 years unless general rule would inappropriately accelerate basis recovery:
 - Seller may request PLR
 - IRS may require basis recovery on non-straight-line basis
 - o Losses are deferred until all amounts have been recovered
 - o Is the transaction really a sale?
- Each payment is treated as part-principal and part-interest. *See Slide 6*

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Method
Limitations

- Applies only to gain, not loss
- Not available for—
 - Sale of inventory property (including bulk sale)
 - Sale of marketable securities
 - Depreciation recapture
- Limited security on installment obligation allowed without ending deferral
- Sale to related party followed by second sale within 2 years ends deferral
- Disposition of installment obligation by holder ends deferral
- Modification of installment note may constitute a disposition, but some modifications are permitted.

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale

Multiple Assets—Allocation of Cash and Installment Obligation

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Allocation to Services or Covenants

- May contingent purchase price be allocated to services provided by Seller or to Seller's covenant not to compete?
- Payment for services—
 - Taxed to Seller on accrual or receipt (cash method) with no basis offset and no deferral charge
 - Usually currently deductible to Buyer as accrued or paid, but deferred compensation rules (§§404(a)(5) and 409A) may defer deduction
- Payment for covenant—
 - Taxed to Seller on accrual or receipt with no basis offset and no deferral charge
 - Amortizable to Buyer under §197

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—Computation, Etc.

- Section 453A imposes a charge for deferring taxable gain under installment method
- Computation:
 - Amount of deferred gain = tax at “maximum rate” on capital gain
 - “Maximum” §1(h) rate for individuals is the 28% rate on sales of collectibles, etc., even though 15% is probably the effective rate on the gain from the sale
 - §1201 determines maximum rate for C corporations
 - Interest rate is the floating underpayment rate
- Deferral charge is treated as interest (§453A(c)(5))
 - Deductible to corporations
 - Not deductible to individuals
- Seller generally may not elect to pay deferred tax early and avoid further deferral charges
 - Installment method has no provision to elect out later, *e.g.*, if interest rates increase (Reg. §15a.453-1(d)(3)(ii))
 - Seller may be able to avoid deferral charges by self-help—disposition (sale or pledge) of installment obligation triggers gain on installment sale
 - Modification of installment note not necessarily a disposition (Rev. Rul.75-457; PLR 201144005)

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

- Deferral charge applies only to—
 - Installment sales of property > \$150,000 sale price
 - > \$5MM aggregate face amount of installment obligations held by Seller at year end (excluding obligations subject to \$150,000 exclusion)
- *De minimis* amounts apply separately to each partner or S corporation shareholder (Notice 88-81, 1988-2 C.B. 397)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—Contingent Payments—General

- Regulations are to be issued on application of §453A to contingent payments (§453A(c)(6)), but no regulations have been issued or proposed
- Can §453A be ignored until regulations become effective?
 - Many contingent obligations do not have a “face amount,” and so *de minimis* rule may apply (or there may be no “installment obligation”)
 - FSA 199941001 (§453A self-executing without regulations)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale

Deferral Charge—Contingent Payments—Possible Computation Methods

- Until §453(c)(6) regs become effective, how is deferral charge computed?
 - FSA 199941001 (deferral charge based on FMV of contingent payment right at closing)
 - TAM 9853002 (no refund of deferral charge based on FMV of contingent payment right at closing, even if contingent payment is never received)
 - If FMV of contingent payment right cannot be determined at closing, is there no deferral charge, even if Seller does not elect out of installment method?
- LAFA 20080101F suggests another method called “look back”
 - Look back method is not described
 - Would Seller pay deferral charge on contingent purchase price when received, regardless of FMV of contingent payment right at closing?

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Election Out—General

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

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Election Out—Erroneous Open Transaction Method

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

Contingent Purchase Price in Taxable Acquisitions Buyer Consequences

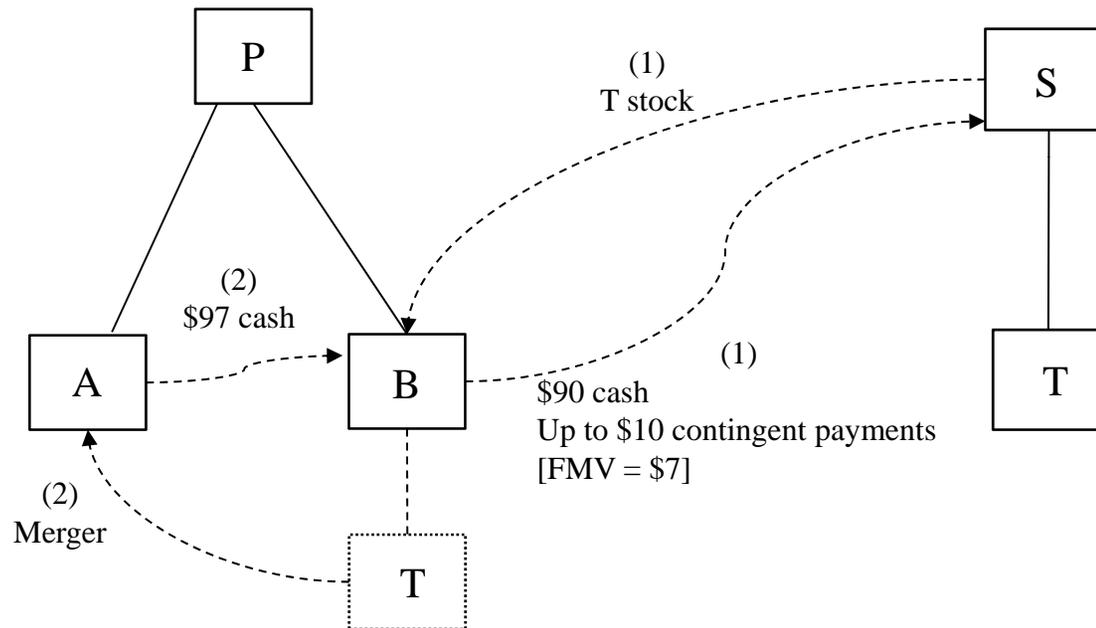
- Buyer gets no asset basis for contingent purchase price until fixed or paid
- Makes no difference which method Seller uses to report sale—even if Seller reports difference between amount realized at closing and amount collected as gain or loss in separate transaction (and so does not adjust its §1060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

Contingent Purchase Price in Taxable Acquisitions

Buyer Consequences

Post-Acquisition Restructuring

Discussion Problem



- B buys the T stock from S for \$90 cash and a right to contingent payments up to \$10 (FMV = \$7)
- B's basis in T stock = \$90.
- T is merged into A in an all-cash D reorganization (Reg. §1.368-2(1))
- Consequence to B is \$97 "boot," taxable to the extent of B's \$7 realized gain on the T stock
- What happens if B pays \$7 of contingent purchase price to S after the year of closing? \$10?

Escrows in Taxable Acquisitions

Escrows in Taxable Acquisitions Issues

- Is Seller deemed to receive escrowed proceeds upon establishment of escrow at closing (installment sale, closed transaction or open transaction)?
- Who is taxed on income earned by the escrowed funds during the escrow period?

Escrows in Taxable Acquisitions

Timing of Inclusion in Seller's Amount Realized

- If escrow protects Seller (*e.g.*, to secure Buyer's payment of purchase price), Seller is deemed to receive escrow proceeds in year of sale
- If escrow is under Seller control (*e.g.*, investment authority), Seller's amount realized includes escrowed funds
 - *Chaplin v. Commissioner*, 136 F.2d 298 (9th Cir. 1943)
 - *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937)
- If escrow protects Buyer (*e.g.*, to secure Seller indemnities), amount realized for escrow proceeds is deferred until payment to Seller becomes fixed
 - IRS agrees that sale with escrow for Buyer's benefit is eligible for installment method (Rev. Rul. 77-294, 1977-2 C.B. 173, *amplified* Rev. Rul. 79-91, 1979-1 C.B. 179; IRS Pub. 537 (citing "substantial restriction" requirement); PLR 200521007)
 - Case law supports contrary argument (*Granneman v. United States*, 649 F. Supp. 949 (E.D. Mo. 1986) (note intended to be paid by Buyer, not out of escrow))
 - Section 453A deferral charge applies if installment method is used
 - If escrow with "substantial restrictions" can be reported on open transaction method, §453A does not apply

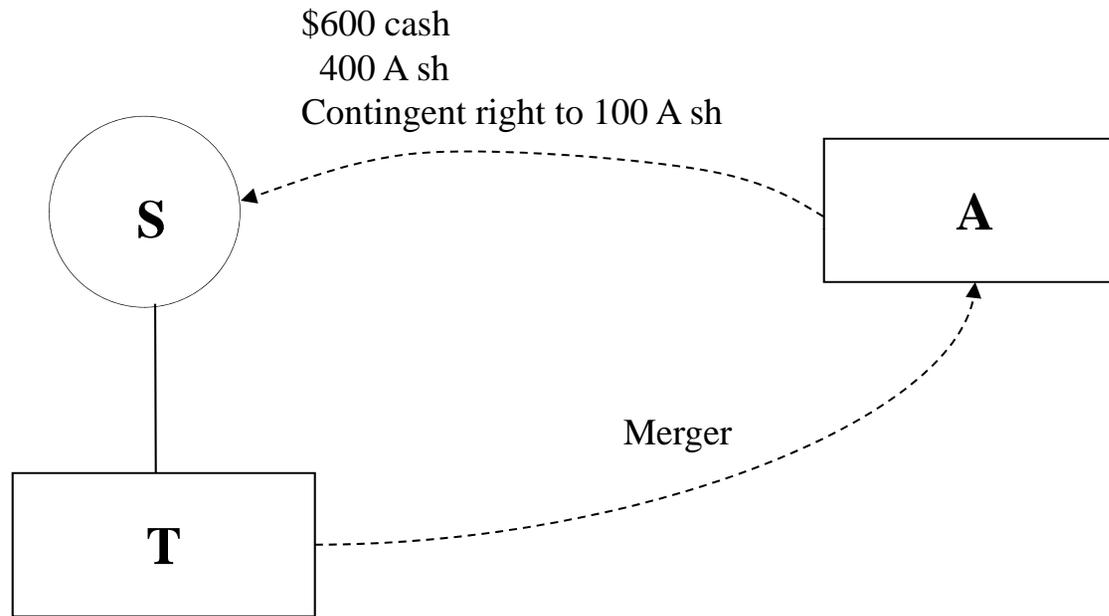
Escrows in Taxable Acquisitions

Taxation of Escrow Income

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

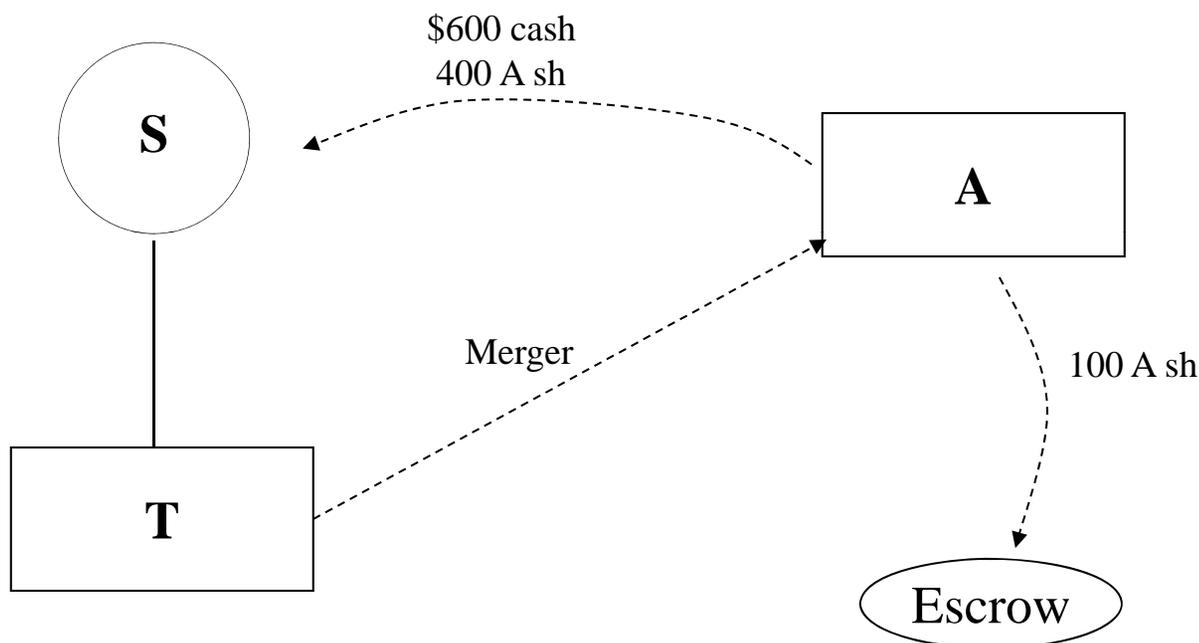
Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations

Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations Discussion Problem 1 Post-Closing Contingent Stock



- T merges into A
- S receives \$600 cash and 400 shares of A stock at closing plus a contingent right to 100 more shares of A stock
- Contingent stock is payable to S if T's business meets performance benchmarks

Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations Discussion Problem 2 Post-Closing Escrowed Stock



- T merges into A
- S receives \$600 cash and 400 shares of A stock at closing plus a contingent right to 100 escrowed shares of A stock
- Escrowed stock issued to S if T's representations and warranties are fulfilled; otherwise, escrowed stock is returned to A
- Variation: Escrowed stock is issued to S if T's business meets performance benchmarks; otherwise, escrowed stock is returned to A

Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations Consequences—Status as Stock and COI

| Issue | Post-Closing Contingent Stock | Post-Closing Escrowed Stock |
|--|---|---|
| General Concept | Treated as issued to Target shareholders when contingencies become fixed | Treated as issued to Target shareholders at closing |
| Status as stock and COI: Rev. Proc. 84-42 | Treated as stock (not boot) and counted toward COI if— | Treated as stock (not boot) and counted toward COI if— |
| | - All stock issued within 5 years after closing | - Same |
| | - Valid business purpose | - Same |
| | - Maximum number of shares stated | - Same implied |
| | - At least 50% of each class of stock is issued at closing | - Same |
| | - Assignment of rights to stock prohibited, or no negotiable certificate | - NA |
| | - Right to receive only stock | - Same implied |
| | - Stock issuance not triggered by event in control of Target shareholders | - Same for return of stock to Acquiror |
| | - Stock issuance not triggered by tax payment or refund resulting from IRS audit | - Same for return of stock to Acquiror |
| | - Mechanism to calculate additional stock to be issued is objective and readily ascertainable | - Same for return of stock to Acquiror |
| | - Principle purpose of triggering mechanism is not Federal income tax avoidance | - Same for return of stock to Acquiror |
| | - NA | - Escrowed stock is legally outstanding and shown as issued on Acquiror's balance sheet |
| | - NA | - Dividends on escrowed stock paid currently to Target shareholders |
| | - NA | - Voting rights on escrowed stock exercisable by Target shareholders or agent |
| | - NA | - No stock to be returned to Acquiror because of death or end of employment "or similar restrictions" |

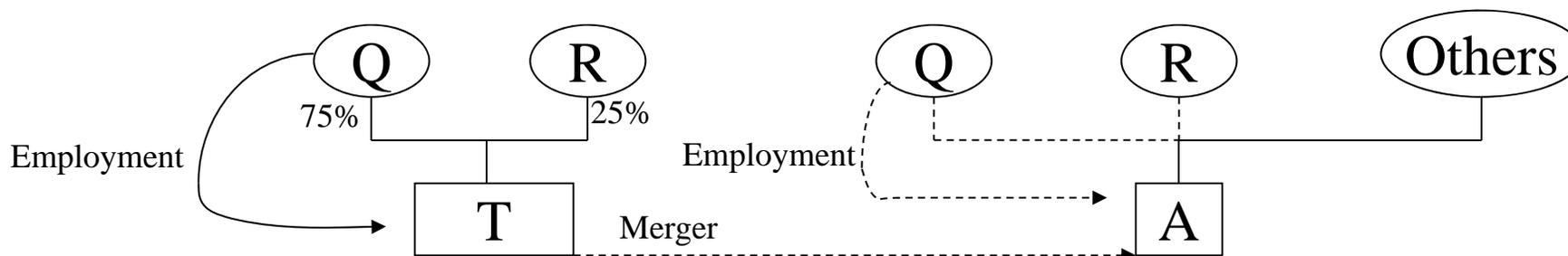
Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations Other Consequences

| Issue | Contingent Stock | Escrowed Stock |
|---|---|--|
| Imputed Interest Income and Deduction | Imputed interest under §483 taxed and deducted when stock issued; no OID; §163(l) probably does not prevent deduction | No imputed interest or OID. Are dividends paid taxable? |
| Consequences When & If Returned to Issuer | NA (stock never issued) | <ul style="list-style-type: none"> • If stock valued as of closing; <i>Arrowsmith</i> adjustment; basis reallocated to remaining shares • If stock valued at time returned, separate taxable redemption for amount of indemnity discharged • May not count against COI as redeemed “in connection with” the reorganization (Rev. Rul. 76-334) |
| Stock Basis | Reallocated among all shares | Escrowed shares take part of overall substituted basis |
| Acquisition of Acquiring Corporation | Does not affect first acquisition, even though stock of second Acquiror is issued (Rev. Rul. 75-456) | Same result, because escrowed stock deemed issued at closing of first acquisition |

Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations

Discussion Problem 3

Compensatory Stock—Facts

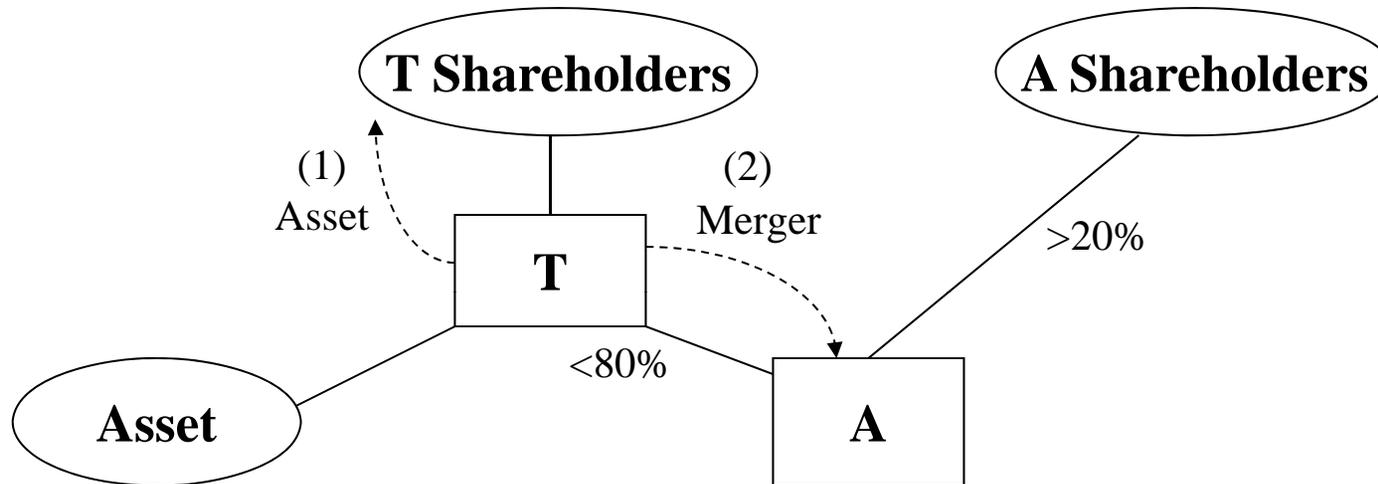


- Q, a key executive of T, owns 75% of the T stock
- R, a passive investor in T, owns the other 25% of the T stock
- A acquires T by merger
 - o R receives A stock, \$1MM FMV
 - R's A stock is not subject to any restriction or risk of forfeiture, and R has no other relationship with A
 - o Q receives A stock, \$3MM FMV
 - Q enters into 5-year employment contract with A
 - If Q ceases to be employed by A before agreement expires (with limited exceptions), Q must sell her A stock back to A for the lesser of \$2MM or its then-FMV

**Post-Closing Contingent Consideration and Escrows
in Acquisitive Reorganizations
Discussion Problem
Compensatory Stock—Analysis**

- How to reconcile tax-free reorganization treatment with §83 tax on compensatory stock?
- In Rev. Rul. 2007-49, 2007-31 I.R.B. 237, *Situation 2*, IRS reconciles the two regimes:
 - Q's receipt of A stock tax-free under reorganization rules
 - By making §83(b) election, Q locks in FMV of A stock at \$3MM and avoids taxable compensation income forever
 - If Q did not make §83(b) election, she would be taxed on FMV of A stock at vesting, less the \$3MM deemed paid for the stock
- Rev. Rul. 2007-49 assumes the transaction qualifies as a reorganization
 - It does not say if the nonvested stock Q receives counts favorably or unfavorably toward COI or neither
 - It does not deal with other COI issues, *e.g.*, whether fluctuations in A stock FMV between signing or closing and vesting dates affect COI
- Q, a service provider, receives nonvested stock, whereas R, a passive investor, receives the same stock consideration but without restrictions
 - This situation is anomalous, because Q is not treated the same as other T stockholder
 - Rev. Rul. 2007-49 avoids the issue of how much A stock is received for T stock and how much for services

**Post-Closing Contingent Consideration and Escrows
in Acquisitive Reorganizations
Contingent Consideration for Tax Attributes
Discussion Problem 4—PLR 200930025 (July 24, 2009) — Facts**



- T owns <80% of the stock of A and Asset
- T has NOL carryover
- T distributes Asset to T Shareholders as taxable dividend
- T is merged downstream into A
 - A inherits T’s NOL carryovers (§381(a))
 - T Shareholders receive—
 - A stock (same amount of A stock as owned by T before merger, but some stock is put in escrow to secure indemnities made by T to A)
 - Right to “Tax Benefit Payments”—cash equal to percentage of T NOL carryovers used by A and refunds of T tax to A

Post-Closing Contingent Consideration and Escrows in Acquisitive Reorganizations

Contingent Consideration for Tax Attributes

Discussion Problem 4—PLR 200930025 (July 24, 2009) — Rulings

- IRS rules
 - Merger qualifies under §368(a)(1)(A)
 - Portion of Tax Benefit Payments taxable to T Shareholders and deductible to A under §483 when paid and received
 - Remaining Tax Benefit Payments are taxed as “boot” under §356(a) when received
- Allows open transaction treatment

Rev. Rul. 57-586, 1957-2 C.B. 249

R. Willens, “An Unusual Way to Monetize a Corporation’s Tax Attributes,” 124 Tax Notes 931 (Aug. 4, 2009)

Anschutz Company v. Commissioner, 135 T.C. 78 (2010), *aff’d* 108 AFTR 2d 2011-7590 (10th Cir. 2011)

In re Steen v. United States, 509 F.2d 1398 (9th Cir. 1975)

**Contingent Consideration and Escrows
in Acquisitive Reorganizations—
Pre-Closing Continuity of Interest**

Contingent Consideration and Escrows in Acquisitive Reorganizations

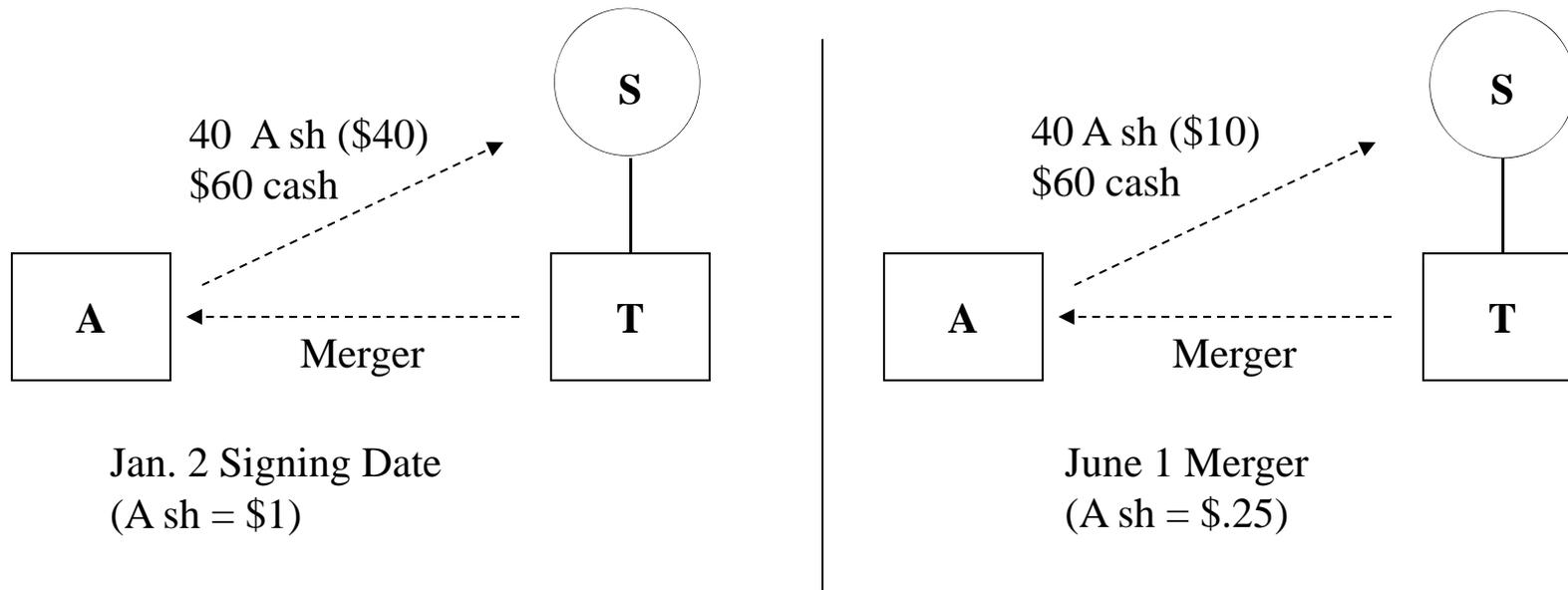
Pre-Closing Continuity of Interest—Signing Date Rule—Background

- Historically, consistent with normal realization concepts, continuity of interest has been measured based on values at the closing date. Treas. Reg. §1.1001-1(a); Rev. Proc. 77-37 §3.02.
- On August 10, 2004, Treasury and IRS proposed regulations to address concern that fluctuation in FMV of Acquiror stock between date parties agree to terms and closing date could cause COI to be failed.
 - Consideration exchanged for Target stock is valued as of end of last business day before binding contract (*i.e.*, signing date), if such consideration was fixed.
 - Proposed signing date rule was based on principle that, if binding contract provides for fixed consideration, Target shareholders are subject to Acquiror's economic fortunes at the signing date.
- On September 16, 2005, Treasury and IRS published final regulations that retained the framework of the 2004 proposed regulations but contained several modifications.
- On March 20, 2007, Treasury and IRS published proposed and temporary regulations that amended the final regulations to allow more flexibility in structuring transactions to satisfy COI.
- The 2007 temporary regulations expired on March 19, 2010, although taxpayers could elect to continue to apply these rules. Notice 2010-25, 2010-1 C.B. 527.
- On December 16, 2011, Treasury and IRS finalized the signing date rule of the 2007 temporary regulations with minor changes.

Pre-Closing Continuity of Interest Signing Date Rule—Fixed Consideration—General

- Signing date rule applies only if binding contract provides for fixed consideration
- Contract provides for fixed consideration if it provides number of shares of each class of Acquiror stock, amount of money and other property to be exchanged for the proprietary interests of Target
- The 2007 temporary regulations had treated a shareholder election to receive stock or other property as providing fixed consideration if amount of stock to be received is determined using its value on the signing date
- The final regulations provide that a shareholder election does not prevent a contract from satisfying general definition of fixed consideration if that requirement is otherwise met
- The final regulations also provide that escrowed stock may be valued at signing date, if the escrow is intended to “secure Target’s performance of customary pre-closing covenants or customary target representations or warranties”
- Signing date rule is used only to determine if COI requirement is satisfied, not for any other purposes (*e.g.*, value of “boot” received, §§368(a)(1)(C), 368(a)(2)(E))

Pre-Closing Continuity of Interest Signing Date Rule—Discussion Problem 1 General



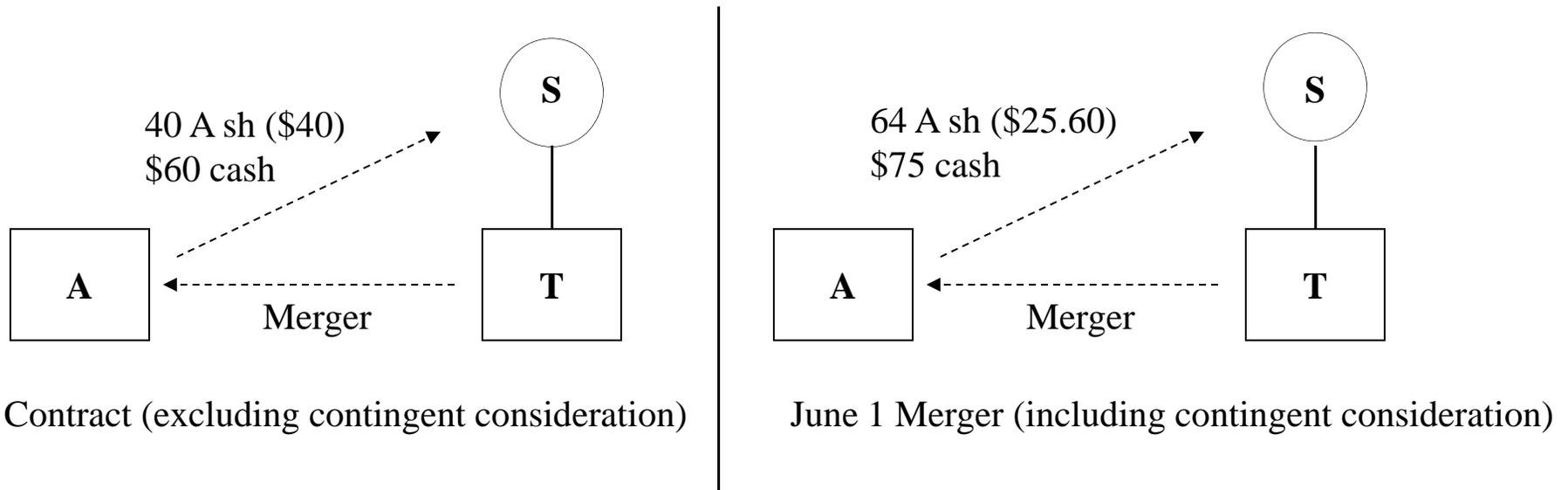
Facts: On January 3, A and T sign a binding contract for merger of T will merge into A. S will receive 40 A shares and \$60 cash for all of T stock. On January 2, a share of A stock is worth \$1. On June 1, T merges into A. On that date, a share of A stock is worth \$0.25.

Result: There is a binding contract providing for fixed consideration, because the contract provides for the number of A shares and an amount of cash for the proprietary interests in T. Thus, FMV of A shares on the signing date (\$1 per share) is used to determine if the COI requirement is satisfied. The 40 A shares constitute 40% of the consideration, and the COI requirement is satisfied.

Pre-Closing Continuity of Interest
Signing Date Rule—Fixed Consideration—
Contingent Consideration

- Binding contracts providing for contingent consideration will be treated as providing for fixed consideration *unless* contingent adjustments prevent (to any extent) Target shareholders from being subject to economic benefits and burdens of ownership of Acquiror stock as of signing date..
- Examples of contingent consideration causing a binding contract *not* to be treated as providing for fixed consideration:
 - Adjustments to consideration if Acquiror stock or assets (or a surrogate of either) increases or decreases after signing date
 - Adjustments to number of shares of Acquiror stock are computed using a share value as of a date after signing date

Pre-Closing Continuity of Interest Signing Date Rule—Discussion Problem 2 Contingent Consideration



Facts: On January 3, A and T sign a binding contract for merger of T into A. On January 2, a share of A stock is worth \$1. In the merger, S will receive 40 A shares, \$60 cash, and a right to \$0.16 of additional A shares and \$0.24 cash for every \$0.01 decrease in FMV of a share of A stock. On June 1, T merges into A. On that date, a share of A stock is worth \$0.40. S receives 64 A shares (worth \$25.60) and \$74.40.

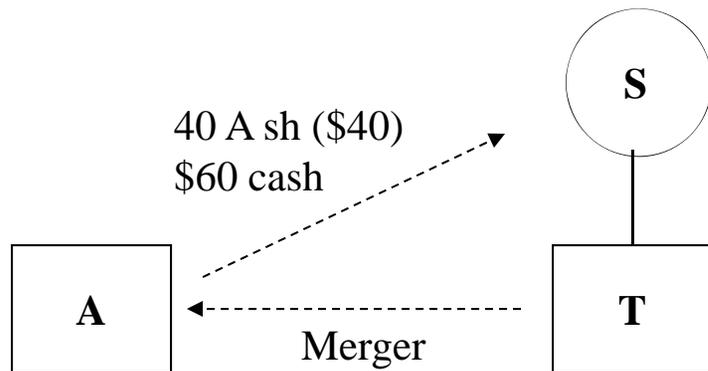
Result: The signing date rule does not apply because the binding contract does not provide for fixed consideration. The additional consideration received by T shareholders is contingent on a decrease in FMV of A stock. As a result, S is not subject to the economic benefits and burdens of A after the signing date. FMV of A stock on the merger date of (June 1) is used to determine if the COI requirement is satisfied. FMV of the A stock (\$25.60) constitutes approximately 25% of the total consideration, and the COI requirement is not satisfied.

If the contingent stock were to be issued based on an increase in the value of T stock or based on T's performance, the signing date rule would apply, and the COI requirement would be satisfied.

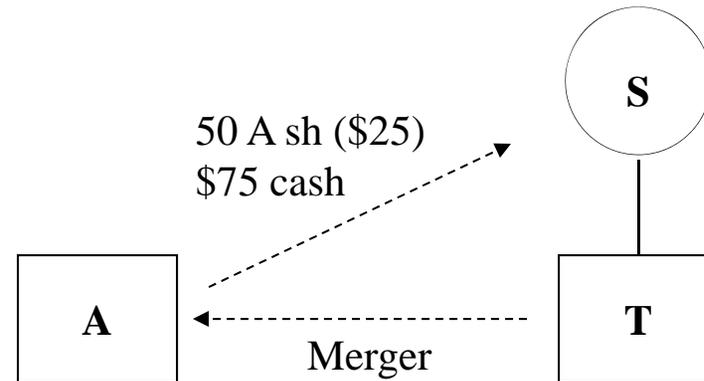
**Contingent Consideration and Escrows
in Acquisitive Reorganizations
Pre-Closing Continuity of Interest—Signing Date Rule—Contract Modification**

- Contract modifications result in new signing date (*i.e.*, last business day before modification is binding).
- Certain modifications do not result in new signing date if COI requirement would have been satisfied in the absence of modification—
 - Modifications that have the sole effect of providing for issuance of additional shares of Acquiror stock.
 - Modifications that have the sole effect of decreasing the amount of money (or other property) transferred to Target shareholders.
 - Modifications that have the effect of decreasing the amount of money or other property to be delivered to Target shareholders and providing for issuance of additional Acquiror stock to Target shareholders.

Pre-Closing Continuity of Interest Signing Date Rule—Discussion Problem 3 Contract Modification



January 2 (Day Before Signing Date)
(A sh FMV = \$1)



March 31 (Day Before Signing Date)
(A sh FMV = \$.50)

Facts: Same as Discussion Problem 1, except that the parties modify the contract on April 1 so that S will receive 50 A shares and \$75 cash. On March 31, a share of A stock is worth \$0.50.

Result: Because the modification provides for additional A shares and cash to be exchanged for the proprietary interests of T, the modification results in a new signing date (April 1). Thus, the value of A shares on March 31 is used to determine if the COI requirement is satisfied. Using that value (\$0.50), the 50 A shares constitute 25% of the total consideration received by S, and the COI requirement is not satisfied.

The COI requirement would have been satisfied if the modification provided only for additional A shares.

Pre-Closing Continuity of Interest Proposed Regulations—Signing Date Rule—Average Value

- On the same day as issuing the final regulations, Treasury and IRS proposed regulations to add flexibility
 - If signing date rule does not apply, proposed regulations would allow use of average value for Acquiror stock in lieu of value of Acquiror stock on “Closing Date” (the date on which the exchange of consideration occurs)
 - Proposed regulations would allow average value of Acquiror stock to be used if—
 - It is based on an average price of Acquiror stock after signing date and before Closing Date
 - The binding contract uses the average price, so computed in determining number of shares of each class of Acquiror stock, amount of money and the other property to be exchanged for all the proprietary interests in Target
- Average price rule does not apply to average prices based on trading before the last day before signing a binding contract
- Like signing date rule, average price rule would be used only to determine if COI requirement is satisfied, not for any other purposes (*e.g.*, value of “boot” received, §§368(a)(1)(C), 368(a)(2)(E))

Pre-Closing Continuity of Interest Proposed Regulations—Contingent Consideration— Floor and Ceiling Rules

The proposed regulations include another method for valuing Acquiror stock for COI purposes

- **Floor Rule:** If—
 - Transaction is pursuant to binding contract
 - Under the contract, amount of “an item of consideration” to be received in exchange for Target stock changes as FMV of Acquiror stock varies *at or above* to a designated “Floor Price” but does not vary further if FMV of Acquiror stock *falls below* the Floor Price
 - On the day before the Signing Date, the FMV of Acquiror stock is *greater than or equal to* the Floor Price (but average price rule may apply)
 - But on the Closing Date FMV of Acquiror stock is *less than* the Floor Price
 - Then, for COI purposes, FMV of Acquiror stock is deemed to be the Floor Price
- **Ceiling Rule:** If—
 - Transaction is pursuant to binding contract
 - Under the contract, amount of “an item of consideration” to be received in exchange for Target stock changes as FMV of Acquiror stock varies *at or below* a designated “Ceiling Price” but does not vary further if FMV *rises above* the Ceiling Price
 - On the day before the Signing Date, the FMV of Acquiror stock is *less than or equal to* the Ceiling Price (but average price rule may apply)
 - But on the Closing Date FMV of Acquiror stock is *greater than* the Ceiling Price
 - Then, for COI purposes, FMV of Acquiror stock is deemed to be the Ceiling Price
- Floor Rule and Ceiling Rule would operate independently of each other and also independently of the average price rule
- Like signing date rule, floor rule and ceiling rule would be used only to determine if COI requirement is satisfied, not for any other purposes (*e.g.*, value of “boot” received, §§368(a)(1)(C), 368(a)(2)(E))

Pre-Closing Continuity of Interest Proposed Regulations—Contingent Consideration—Floor and Ceiling Rules Discussion Problem—Collar

Facts

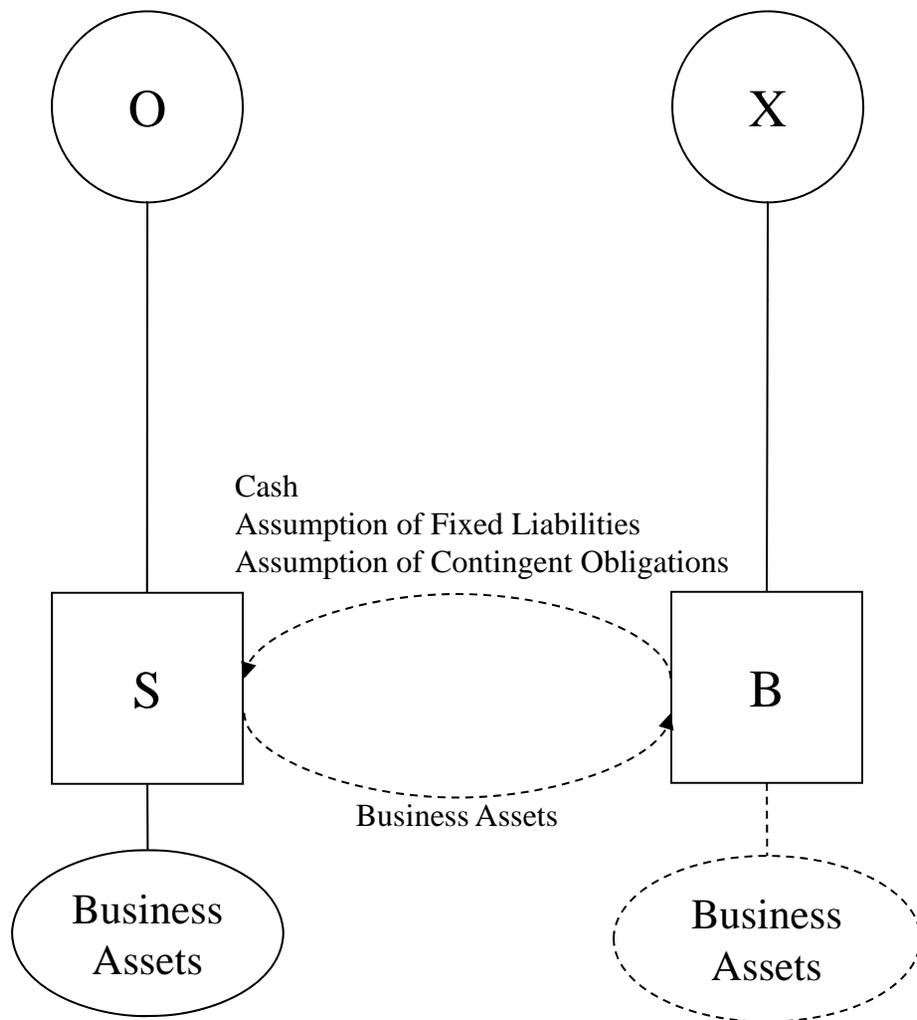
- On January 2, Acquiror stock FMV is \$1/share
- On January 3, P and T sign a binding contract to merge Target into Acquiror
- Target shareholders will receive 50 shares of Acquiror stock and \$50 cash, subject to adjustment based on average traded price of Acquiror stock over designated post-signing and pre-closing time period:
 - If average price is > \$1/share, cash is reduced by 50x excess of average price over \$1, but not to < \$40
 - If average price is < \$1/share, cash is increased by 50x excess of \$1 over average price, but not to > \$60
- Adjustment ensures receipt of total consideration with \$100 FMV if average price of Acquiror stock is:
 - At least \$0.80 “Floor Price”: $\$60 \text{ maximum cash} = \$50 + (50 (\$1.00 - \$0.80))$
 - No higher than \$1.20 “Ceiling Price”: $\$40 \text{ minimum cash} = \$50 - (50 (\$1.20 - \$1.00))$
- On June 1, Target merges into Acquiror, when the average price is \$0.25 per share
- Thus, the Target shareholders receive \$60 cash and 50 shares of Acquiror stock with \$12.50 FMV.

Conclusions

- COI is determined as if the average price were the Floor Price (\$60 cash and \$40 Acquiror stock)
 - Cash consideration did not vary as average price fell below Floor Price (\$0.80/share)
 - FMV on day before signing > Floor Price
 - FMV on Closing Date < Floor Price
- If Acquiror stock price had increased to above Ceiling Price, the ceiling rule would have applied

Contingent Obligations in Taxable Asset Acquisitions

Assumption of Contingent Obligations in Taxable Asset Acquisitions — Discussion Problem



- **Year 1:** B buys Business Assets from S
- B pays cash and assumes S's fixed liabilities and contingent obligations
- S's contingent obligations include:
 - Vested and non-vested deferred compensation to employees
 - Medical benefits to retirees
 - Product warranty and product liability claims (no claim pending)
 - EPA examination of waste sites but no clean-up or payment yet required
 - Pending lawsuit for patent infringement
 - Fixed-price contracts to buy commodities, some at higher, and others at lower than market prices
- Disposition of contingent obligations:
 - **Years 2-4:** B pays deferred compensation, some vested before and some after the acquisition
 - **Each year:** B pays medical benefits to retirees
 - **Each year:** B pays warranty claims in amounts less (or more) than expected
 - **Year 5:** B pays for clean-up of S's waste site
 - **Year 6:** B pays an unexpected judgment in the patent case
 - **Years 1-6:** B complies with all fixed-price contracts

Assumption of Contingent Obligations in Taxable Asset Acquisitions Possible Tax Treatments

- Almost every acquisition involves contingent obligations of the acquired business
 - Environmental obligations
 - Tort liabilities
 - Warranty claims
 - Retiree medical expenses
- Issue arises when Buyer business assets and then pays or incurs a liability attributable to acquired business
- Three tax treatments possible
 - Buyer expense, usually deductible by Buyer when paid or accrued
 - Seller contingent obligation assumed, *i.e.*, Seller expense paid by Buyer
 - Capitalized by Buyer in price paid for purchased assets
 - Added to Seller's amount realized on sale, with offsetting deduction
 - "Fee" analysis

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Buyer Expense Treatment**

- Buyer “steps into shoes” of Seller and deducts or capitalizes obligation
- Deduction or asset basis increase occurs when obligation is accrued or paid (economic performance) under general tax accounting rules
- No gain, income or deduction to Seller

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
General**

Seller

- Inclusion in amount realized on sale
- Offsetting deduction
- Imputed interest income
- Installment reporting

Buyer

- Capitalize payment but only when accrued and economic performance occurs
- Imputed interest expense

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Seller**

Inclusion in Amount Realized

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

Is Interest Imputed on Deemed Payment?

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

Installment Reporting

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

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Seller (Continued)**

Does Seller get offsetting deduction against amount realized?

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

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Seller (Continued)**

When does Seller get offsetting deduction against amount realized (continued)?

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

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Seller (Continued)**

When does Seller get offsetting deduction against amount realized (continued)?

- Similar problem arises where obligation is to pay nonqualifying deferred compensation
 - Section 404(a)(5) – employer gets deduction when employee has income
 - IRS position: deemed payment found in *Commercial Security Bank*, etc. does not support a deduction until income to employee (TAM 8939002)

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Buyer**

- Treat assumed obligation as cost of purchased assets and add to asset basis
- Capitalization approach has greater support in case law
 - *Webb v. Commissioner*, 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983)
 - Unfunded pension obligation assumed in asset acquisition
 - Payments treated as cost of acquired assets
 - *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946), *Pacific Transport; M. Buten & Sons v. Commissioner*, T.C. Memo 1972-44
- Uncertain whether Buyer may treat a portion of the payments as currently-deductible interest when made (no OID)
 - Section 1274 does not apply to obligation assumptions
 - Does §483 apply?
- Addition to asset basis is delayed to when obligation becomes fixed (accrual and economic performance)
- But, if Buyer sells asset subject to the same contingent obligation before the obligation is added to asset basis, assumption of the obligation from Buyer is excluded from Buyer's amount realized on this sale (Reg. §1.1001-2(a)(3))

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Consequences
Fee Treatment**

- In *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (1964), Seller owned a newspaper and received prepaid subscription fees
 - Seller initially set up a reserve and deferred the income under §455
 - Court held that when Seller sold the business, it had to accelerate the reserve into income
 - But the court also gave Seller a deduction
 - Buyer paid cash for reserve
 - Seller is deemed to turn around and pay Buyer a fee for assuming obligation to fill newspaper subscriptions
 - Thus Seller's income from the reserve was offset with a deduction for the "fee"
 - Deemed receipt of fee would be currently taxable to Buyer
 - Deemed reduction in purchase price for assumption of obligation is added back to Buyer's basis in purchased assets at closing
 - Payment of obligation should be currently deductible
 - *See also* Rev. Rul. 71-450

Assumption of Contingent Obligations in Taxable Asset Acquisitions

Consequences

Fee Treatment

Other Authorities

- *TFH Publications v. Commissioner*, 72 T.C. 623 (1979): Acquisition of publishing company assets with agreement to provide future advertising services at a discount
- TAM 9823992: Prepaid subscription income treated as obligation assumed
- Fee approach has not received much support outside publication industry
- But preamble to a consolidated return regulation (T.D. 9376 (Jan. 16, 2008)) implies that fee theory applies in §332 liquidation if shareholder assumes obligation to provide future services (but supporting example involves prepaid subscription income)
- Different approach is implied in *In re Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (buyer of uranium mine paid seller additional purchase price due to favorable state tax decision; *held*, open transaction; fee income to buyer not asserted)

**Assumption of Contingent Obligations
in Taxable Asset Acquisitions
Factors in Determining Treatment**

- Does the obligation result from Seller's or Buyer's activities
- Does the obligation arise out of pre-acquisition or post-acquisition events
- Did legal obligation arise before or after closing?
- Is there is express assumption by Buyer of the obligation and reflection in price?
- Was Buyer aware of obligation (balance sheet reserve) at closing?

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

First Factor: Results from Seller or Buyer Operations—*Holdcroft*

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

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

First Factor: Results from Seller or Buyer Operations—Other Authorities

- *Albany Car Wheel v. Commissioner*, 333 F.2d 653 (2nd Cir. 1964) – obligation arose after acquisition due to Buyer’s decision to close plant
- Rev. Rul. 76-520 – Buyer acquired newspaper business
 - Costs of filling prepaid subscriptions was assumed obligation because it relates to Seller operations
 - Costs of selling newspapers at newsstands deductible because they related to Buyer operations
- TAM 9721002 – acquisition and severance pay
 - “[A]lthough severance payments here were coincidental with Buyer's acquisition of Target, the severance payments had their origin in Buyer's termination of Target employees. While the acquisition may have been the catalyst for the employees' receipt of the severance payments, the acquisition was not itself the basis for the payments. Accordingly, the severance payments need not be capitalized and added to the basis of the stock purchased.”
- *Illinois Tool Works v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
 - Because the taxpayer knew of the pending patent infringement lawsuit, and agreed to pay that contingent obligation in exchange for purchasing the company, the taxpayer was not entitled to currently deduct the judgment as a business expense

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Second Factor: Arises Out of Pre-Acquisition or Post-Acquisition Events

- A factor closely related to the first factor is whether the obligation arises out of pre- or post-acquisition events
- For example, employee benefit cases:
 - Where there is a contract in place at time of acquisition to pay death benefits to employees
 - If employee dies after closing, obligation should be a Buyer obligation
 - If employee has died and Seller is obligated to pay, Buyer assumes obligation—no deduction to Buyer
- *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44
 - Corporation agreed to assume liabilities of partnership in §351 transaction, including death benefits to surviving widows
 - No deduction for payments to widow of employee who died before the acquisition
 - Payments were deductible if employee died after the acquisition
- *David R. Webb Co., Inc. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983)
 - Buyer assumed Sellers obligation to make pension payments to wife of previously deceased employee
 - No deduction to Buyer

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Third Factor: When did Legal Obligation Arise?

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

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Fourth Factor: Was Buyer Aware of Obligation?

- *Pacific Transport v. Commissioner*, 483 F.2d 209 (9th Cir. 1973)
 - Parent corporation liquidated subsidiary (§334(b)(2)) and took assets and assumed liabilities, including a lawsuit
 - Parent believed its risk on the claim was remote.
 - Parent's risk assessment was wrong, and it ultimately paid claim.
 - Tax Court held that deduction was allowed, because claim was speculative and remote
 - Appeals court reversed and held that contingency was irrelevant
 - Because Buyer was aware of obligation, payment of claim was a cost of acquiring assets
 - No exception to capitalization for bad bargains
- Reserve for liability on Seller's balance sheet would make Buyer aware of obligation
- *But see Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946)

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

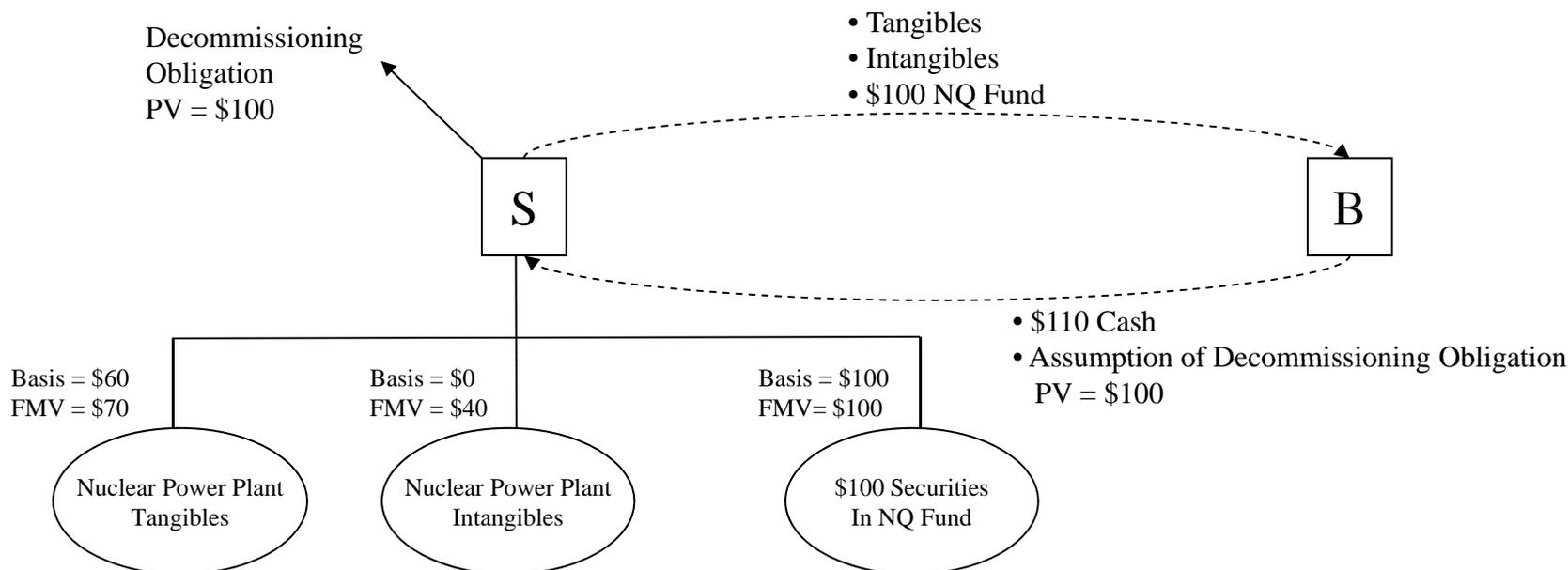
Fifth Factor: Obligation Expressly Assumed by Buyer and Reflected in Price

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

Assumption of Contingent Obligations in Taxable Asset Acquisitions Contracts Transferred to Buyer

- Acquired business may have favorable or unfavorable contracts, or both
- Favorability of a contract may be measured by reference to expected profit or loss on compliance or, even if profit is expected, based on baseline margin
- Under GAAP purchase accounting (PACO), Buyer must reserve for estimated costs of compliance with unfavorable contracts as additions to purchase price (FASB Statement No. 38)
- Consequently, if Buyer deducts these costs for tax purposes, Schedule M adjustments result
- Unfavorable contracts could be viewed as reduced-value assets instead of contingent liabilities under §1060, resulting in costs deductible to Buyer
- If net costs of compliance with unfavorable contracts were treated as contingent liabilities, should net income from favorable contracts be excluded from Buyer's income and treated as reduction in purchase price?
- PLR 200730014 (July 27, 2007)
 - Purchaser of gas marketing business paid customers to terminate pre-existing contracts to supply gas at fixed price and substitute contracts at fluctuating prices
 - Payments deductible to Buyer, not capitalized as adjustments to purchase price, because—
 - Obligations contingent on customers' gas purchases and market price
 - Contracts not taken into account in determining purchase price
- *Albany Car Wheel*
 - No step-up in cost basis of business assets for Buyer's payment of severance pay
 - Buyer negotiated new collective bargaining agreement providing for severance pay
- *See also* §1274(c)(4) (in asset purchase, interest not imputed to account for favorable or unfavorable financing)

Assumption of Contingent Obligations in Taxable Asset Acquisitions — Discussion Problem Nuclear Power Plant Decommissioning



- S owns a nuclear power plant
 - S's basis in tangibles is \$60, and their FMV is \$70
 - S's basis in intangibles is \$0, and their FMV is \$40
 - The plant is expected to be decommissioned in 2051 at \$500 cost (present value \$100)
 - S has set aside securities (\$100 basis and FMV) in a "nonqualified fund" to fund this cost
- S sells the plant to B in 2011
 - S transfers the tangibles, intangibles and nonqualified fund to B
 - B pays S \$110 cash and assumes the decommissioning cost obligation
- Between the sale and 2051, the securities in the nonqualified fund increase in FMV to \$500
- In 2051, the plant is decommissioned at \$500 cost, paid out of the fund

PLR 200004040 (January 31, 2000) and other PLRs

Reg. §1.338-6(c)(5)

Contingent Obligations in Taxable Stock Acquisitions

Contingent Obligations in Taxable Stock Acquisitions Non-Consolidated Return Situations

- If Target stock is sold, and if contingent obligations remain with Target, the obligations should be reflected in purchase price
- Otherwise, there is no immediate tax effect to either Seller or Buyer
- Generally, there are no special consequences when the obligations become due and are paid
- Target deducts or capitalizes accrual and/or payment in accordance with usual tax accounting rules

**Contingent Obligations in
Taxable Stock Acquisitions
Consolidated Return Regulations
Transition Issues**

- If Seller sells Target stock during a consolidated return year, planning is needed:
 - If the contingent obligation generates a deduction on the day of sale, either the Seller's group or the Buyer's group may be claim the deduction, if the parties are consistent (Reg. §1.1502-76(b))
 - If the obligation is for deferred compensation under §404(a)(5), the deduction may have to belong to the Buyer's group
- If Seller's group claims the deduction—
 - Seller's basis in the Target stock is reduced (Reg. §1.1502-32), and its gain on the stock sale is increased (or its loss is decreased) by the same amount
 - If Target has a separate company loss for the year, this loss would seem to shelter gain on a sale of Target stock, but it would also reduce Seller's basis in the Target stock and so increase that gain. Thus, \$1 gain on the Target stock could use, or “churn and burn” all of Target's loss. The “anti-churn-and-burn” rule (Reg. §1.1502-11(b)) prevents this result by prohibiting Target's loss from offsetting gain on a sale of Target stock
- If Buyer's group is entitled to the deduction, a loss limitation under §382(h) or a separate return limitation rule (SRLY) limitation may result

**Contingent Obligations in
Taxable Stock Acquisitions
Consolidated Return Regulations
Loss Disallowance or Attribute Reduction**

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

Contingent Obligations in Tax-Free Transactions

**Assumption of Contingent Obligations
in Tax-Free Transactions
Acquisitive Reorganizations
Treatment**

- Treatment of contingent liabilities in acquisitive reorganizations is codified (§§381(c)(4) and (c)(16); Reg. §§1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a))
- Acquiror steps into Target's shoes and may deduct otherwise-deductible liability items assumed from Target
- Nondeductible liability items assumed from Target do not become deductible to Acquiror

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

Rev. Rul. 73-146, 1973-1 C.B. 61 (payment to Target employee to terminate stock options before type-B reorganization deductible as compensation)

**Assumption of Contingent Obligations
in Tax-Free Transactions
Acquisitive Reorganizations
Effect on Tax-Free Status**

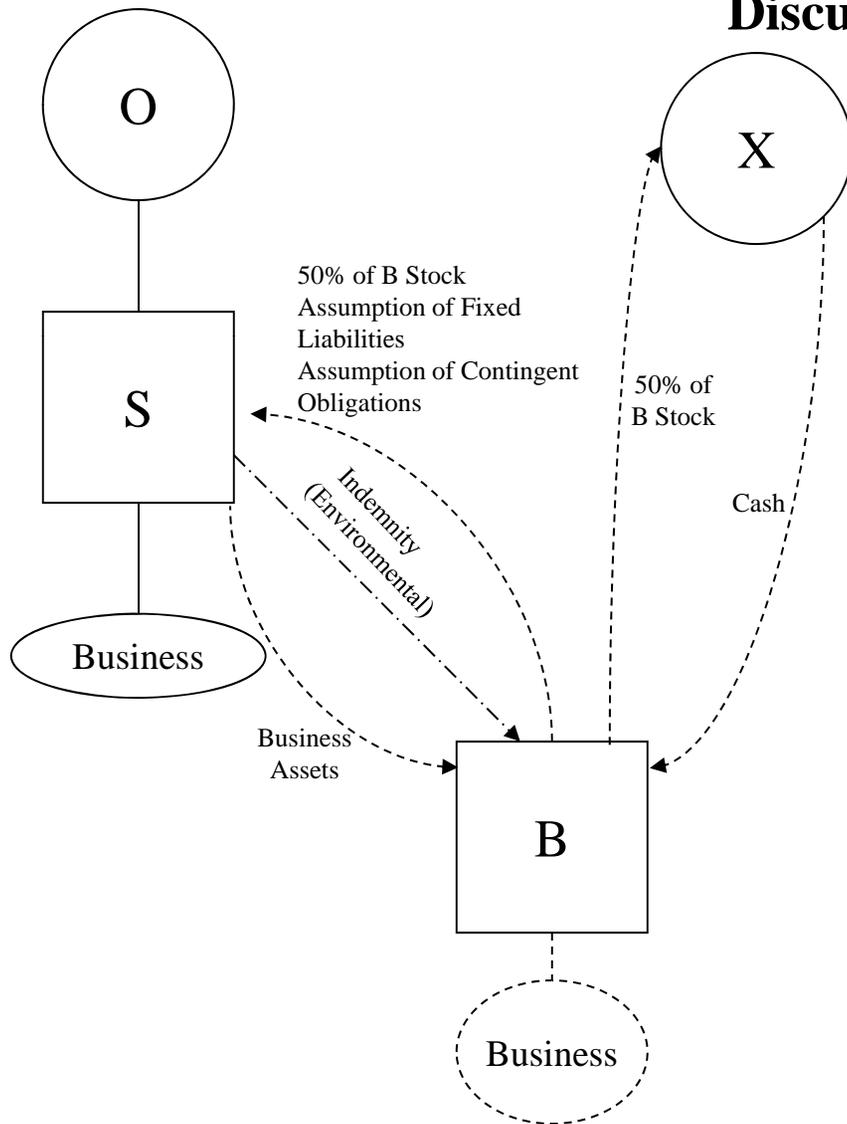
- Contingent liabilities are like other liabilities for purposes of determining whether assumption is taxable as “boot”
- Generally, only the “acquiring corporation,” defined in Reg. §1.381(a)-1(b)(2), may assume liabilities tax-free
- In triangular reorganizations, the parties must be careful in structuring to be sure the correct corporation “assumes” liability within the meaning of §357(d)

Rev. Rul. 70-107, 1970-1 C.B. 78

Rev. Rul. 70-224, 1970-1 C.B. 79

Rev. Rul. 73-257, 1973-2 C.B. 189 (in triangular acquisition, parent may assume Target liabilities if acquisition is a merger)

Assumption of Contingent Obligations in Tax-Free Transactions Tax-Free Incorporation Discussion Problem



- X and S form B, a new corporation
- X transfers cash to B for 50% of the B stock
- S transfers Business Assets to B for 50% of the B stock
- B assumes S's contingent obligations, including:
 - Cleanup of S's waste sites
 - EPA examination underway but no clean-up or payment yet required
 - S agrees to indemnify B for cleanup cost above fixed amount
 - Pending lawsuit for patent infringement
- Disposition of contingent obligations:
 - **Year 5:** B pays for clean-up of S's waste site, and S pays its part of the cost
 - **Year 6:** B pays unexpected judgment in patent case

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Incorporations
General Rule on Deductions**

- Section 381 does not apply to transfers of assets under §351
- Without §381, corporate transferee is subject to case law treating liability assumptions as part of cost of property and so capitalized when paid (not deducted by transferee and perhaps not by transferor either)
- If transferor does not recognize gain (as would be the case for liability assumption, unless §357(b) or §357(c) applied), transferee would get no asset basis either

Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946)

F. Tinker & Sons Co. v. Commissioner, 1 B.T.A. 799 (1925)

Caldwell & Company v. Commissioner, 26 B.T.A. 790 (1932), *aff'd per curiam*, 65 F.2d 1012 (2d Cir. 1933)

Automatic Sprinkler Company of America v. Commissioner, 27 B.T.A. 160 (1932)

F. S. Stimson Corp. v. Commissioner, 43 B.T.A. 303 (1938)

Brown Fence & Wire Co. v. Commissioner, 46 B.T.A. 344 (1942)

Portland Gasoline Company v. Commissioner, 181 F.2d 538 (5th Cir. 1950)

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Incorporations
Special Rule on Deductions
Rev. Rul. 95-74**

- Even though §381 does not apply to §351 transactions, IRS has ruled that a contingent liability assumed in a §351 transfer of business associated with the liability resulted in deductions *to transferee* as payments were made (Rev. Rul. 95-74, 1995-2 C.B. 36)
- This *ad hoc* “step-in-the-shoes” treatment is limited to transfers of full businesses, with business purpose
- Rev. Rul. 95-74 does not spell out all the consequences of “step-in-the-shoes” treatment, but there should be—
 - No gain recognition to transferor
 - No reduction in transferor’s basis in stock of transferee corporation
 - No increase in transferee’s basis in transferred assets
- IRS concern was with transfers of contingent liabilities to corporation and sale of stock, resulting in accelerated and duplicated loss
- In 2001, enactment of §358(h) eliminated loss created in this manner

Notice 2001-17, 2001-1 C.B. 730

FSA 199905008 (Oct. 29, 1998), *reconsidered by* FSA 199929015 (Apr. 20, 1999)

TAM 200006014 (Oct. 22, 1999)

CCA 200117039 (Apr. 27, 2001)

FSA 200121013 (May 25, 2001)

FSA 200122022 (June 1, 2001)

FSA 200134008 (Aug. 24, 2001)

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Incorporations
Transferor Stock Basis—Section 358(h)**

- In a §351 exchange, if transferee corporation assumes a liability from transferor, transferor's basis in stock received is reduced (§357(a))
- But there is no stock basis reduction if assumed liability has not yet been taken into account under the Code (to produce deduction or asset basis)
- Section 358(h)(1), enacted in 2000, eliminates duplicated losses by reducing basis of stock received by transferor under §351, to extent—
 - Stock basis > FMV, and
 - Transferee corporation assumes “liability”
- “Liability” includes contingent liabilities, even if not yet taken into account under the Code
- Exception: Under §358(h)(2), stock basis is not reduced by liability if assets transferred to corporation include—
 - Trade or business associated with liability
 - Substantially all assets associated with liability (but Treasury has eliminated this exception, in Treas. Reg. §1.358-5)

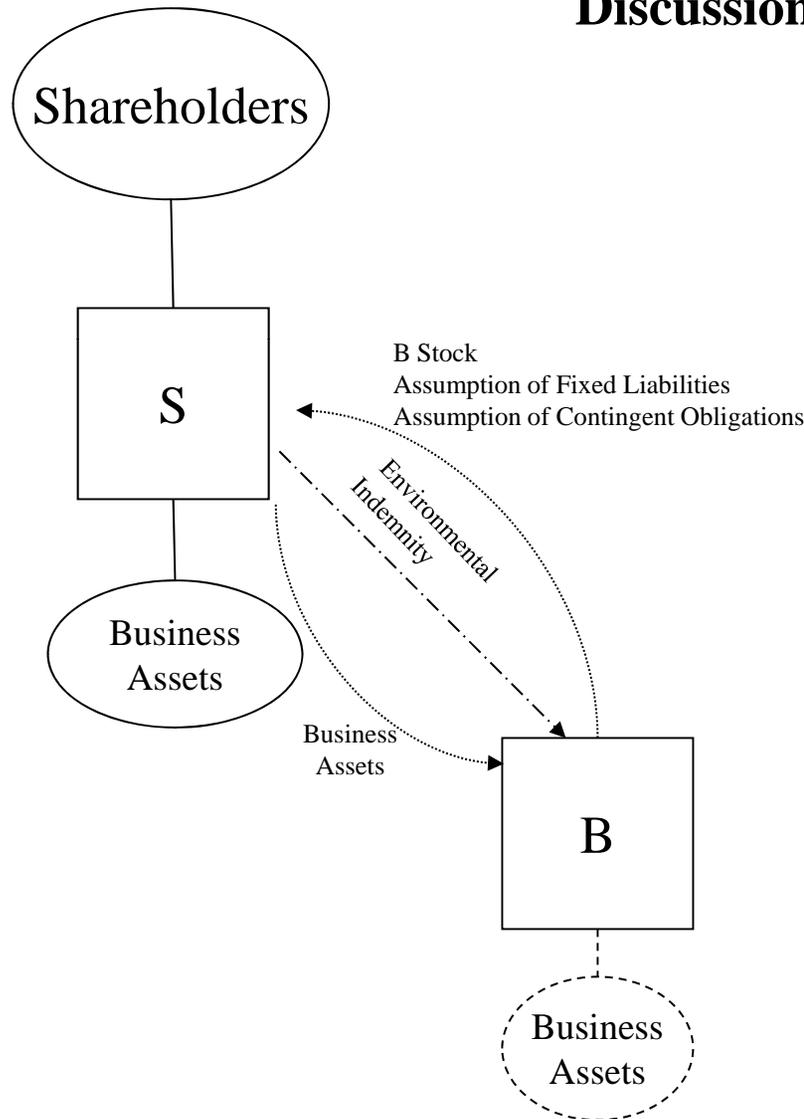
**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Incorporations
Section 362(e)(2)**

- Section 362(e)(2), enacted in 2004, eliminates duplicated losses resulting from transfers to corporations of built-in loss property
 - Reduces basis of transferred property from carryover to FMV, unless transferor and transferee jointly elect to reduce the basis of the stock received in exchange from substitute to FMV (usually the more attractive option)
 - Because it applies only when asset basis > FMV, §362(e)(2) does not directly affect treatment of contingent liabilities, except in the unusual situation where the contingent liability is included in asset basis
 - Suppose built-in loss assets (basis > FMV) are transferred, and transferee also assumes contingent liability not included in asset basis
 - Built-in stock loss > built-in asset loss
 - But, if stock basis reduction is elected, amount of stock basis reduction is the same as asset basis reduction would have been (Prop. Reg. §1.362-4(c)(3))
- This regime puts pressure on the issue of whether a contingent payment related to particular property (*e.g.*, environmental remediation) affects FMV of the property or is a separate item

Assumption of Contingent Obligations in Tax-Free Transactions

Tax-Free Divisive Reorganizations

Discussion Problem



- S forms B, a new corporation
- S transfers Business Assets to B for 100% of the B stock
- B assumes S's contingent obligations, including:
 - Cleanup of S's waste sites used in Business
 - EPA examination underway but no clean-up or payment yet required
 - S agrees to indemnify B for cleanup cost above fixed amount
 - Pending lawsuit for patent infringement
- B distributes the B stock to Shareholders
- Disposition of contingent obligations:
 - **Year 5:** B pays for clean-up of S's waste site, and S pays its part of the cost
 - **Year 6:** B pays unexpected judgment in patent case

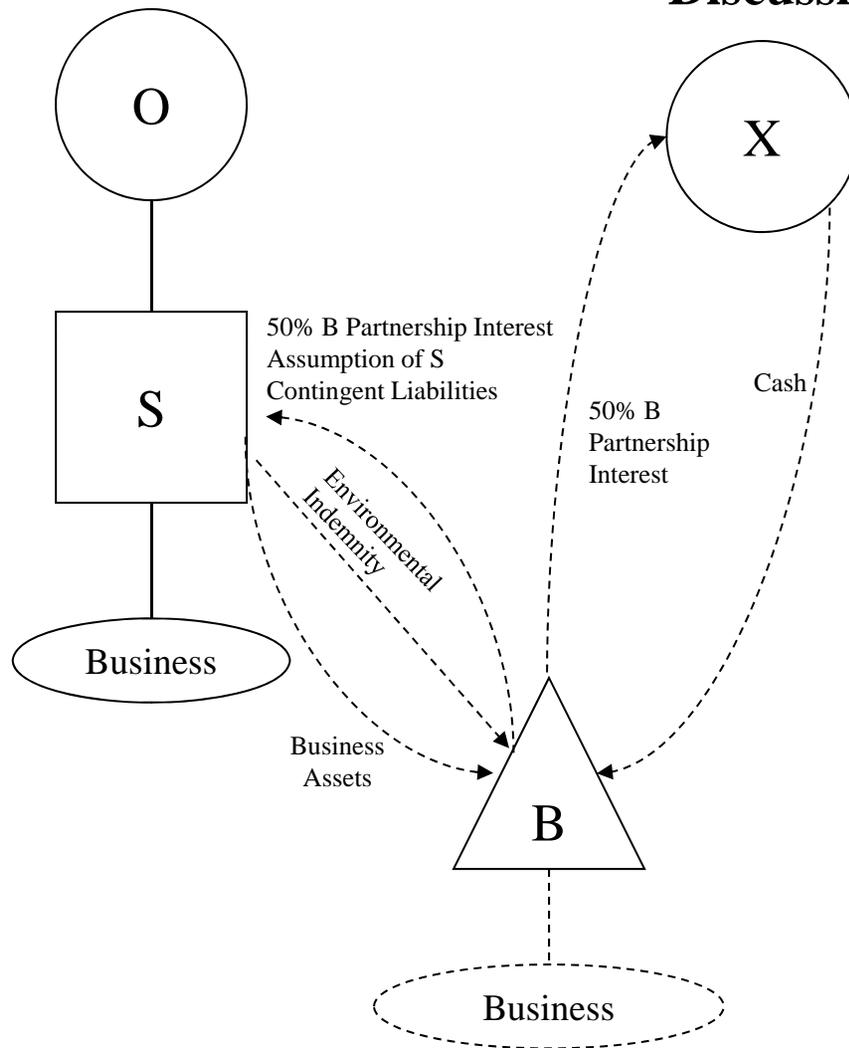
**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Divisive Reorganizations
Similarity to Tax-Free Incorporations**

- In a divisive type-D reorganization (§355), Distributing may retain or Controlled may assume contingent obligations relating to spun-off business
- IRS has ruled that payments between Distributing and Controlled under such agreements relate back to before spin-off (*e.g.*, PLR 199919025 (February 12, 1999))
 - IRS does not specify treatment of payment as, *e.g.*, distribution, “boot” or a capital contribution
 - IRS does not rule on which party (if any) is entitled to deduction when obligation is paid
- Under §357(d)—
 - “Assumption” by Controlled can be effected by legal assumption or indemnity to Distributing
 - “Assumption” is the same in divisive type-D reorganization as in §351 exchange
- As in §351 exchange, 381 does not apply
- Rev. Rul. 80-198 and Rev. Rul. 95-74 should apply to a divisive type-D reorganization, as to a §351 exchange, to allow Controlled to step into shoes of Distributing and deduct payment of contingent obligations to same extent as Distributing could have done if no assumption had occurred (CCA 201023056 (Sept. 22, 2009) so concludes)
- Sections 358(h) and 362(e) do not apply, because the basis of the Controlled stock disappears in the spin-off (§§358(b)(2), (c))

Assumption of Contingent Obligations in Tax-Free Transactions

Tax-Free Partnership Transfers

Discussion Problem



- S and X form new partnership B
- X transfers cash to B for a 50% interest
- S transfers Business Assets to B for 50% interest
- B assumes S's contingent obligations, including:
 - Cleanup of S's waste sites
 - EPA examination underway but no clean-up or payment yet required
 - S agrees to indemnify B for cleanup cost above fixed amount
 - Pending lawsuit for patent infringement
- Disposition of contingent obligations:
 - **Year 5:** B pays for clean-up of S's waste site, and S pays its part of the cost
 - **Year 6:** B pays unexpected judgment in patent case

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Partnership Transfers
Former Retroactive Regulations**

- Reg. §1.752-6 applied §358(h)-like rule to liability assumptions from October 18, 1999, through June 23, 2003
- In transfer of property to partnership for partnership interest, if partnership assumes “liability” (defined to include contingent liabilities and the like), partner’s basis in partnership interest is reduced
 - Amount of reduction is full amount of liability, but only to eliminate built-in loss in partnership interest
 - Exceptions applied to transfer of trade or business associated with liability and transfer of substantially all assets associated with liability
 - For “Son-of-BOSS” and substantially similar transactions (Notice 2000-44, 2000-2 C.B. 255), “substantially all” exception did not apply
- Preamble explains retroactive treatment by referring to a non-Code statute directing Treasury to prescribe §358(h)-like rules for partnership transactions
- Taxpayers could elect Reg. §§1.752-1 and 1.752-7 instead of Reg. §1.752-6
- Election had to be filed with partnership’s return filed from September 24, 2003, to December 31, 2005
- Reg. §1.752-6 had mixed reception from courts in “Son-of BOSS” cases, but outcomes have favored government (M. Jackel & R. Crnkovich, “Son-of-BOSS Revisited,” 123 Tax Notes 1481 (June 22, 2009))

Assumption of Contingent Obligations in Tax-Free Transactions

Tax-Free Partnership Transfers

Current Regulations

- Reg. §§1.358-7, 1.752-1 and 1.752-7 embody a rethinking of partnership contingent liabilities to prevent double deductions and reassignment of deductions away from partner that incurred cost
- Most innovative feature is broad concept of “obligation”:
- “Obligations” are all obligations to make payments, including contingent, regardless of whether taken into account under the Code (*e.g.*, to create deduction or asset basis)
- Broad concept of obligation is divided into two categories for §752 purposes:
 - “Liabilities” are obligations that have been (or never will be) taken into account under the Code
 - “Liabilities” continue to be taken into account under normal tax accounting principles
 - Allocated among partners and affect basis in partnership interests as before
 - Other “obligations” (“§1.752-7 liabilities”) have not yet been taken into account under the Code but will be taken into account in the future (generally, contingent obligations)
- Regulations establish new regime to deal with partner’s §1.752-7 liabilities assumed by partnership or other partners
- One possible approach was to require reduction in partner’s basis in partnership interest when a §1.752-7 liability is assumed by partnership and allocated to another partner, but this approach would have led to two problems:
 - Would have allowed the tax benefit (*e.g.*, business expense or depreciation deduction) generated by the §1.752-7 liability to be reallocated from partner that incurred the liability to other partners
 - When §1.752-7 liability is paid or otherwise taken into account, second basis reduction would have been suffered by partners to whom liability was allocated

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Partnership Transfers
Current Regulations (Continued)**

- Instead, regulations identify liability with partner who transferred it to partnership
- Deduction or asset basis attributable to §1.752-7 liability remains with partner that incurred the §1.752-7 liability (the “§ 1.752-7 liability partner”), under §704(c) principles
 - When partnership satisfies a §1.752-7 liability, resulting deduction or asset basis is allocated to § 1.752-7 liability partner who incurred liability, to the extent of built-in loss
 - Reduction in liability allocated to §1.752-7 liability partner reduces partnership interest basis
 - Section 704(c) regulations were amended to treat partnership property whose basis is increased when §1.752-7 liability is paid “as §704(c) property with the same amount of built-in loss as corresponds to the amount capitalized”
- Rule is similar to treatment of assumed contingent liabilities in asset sales
- But, unlike asset sale rule, amount of §1.752-7 liability allocated to §1.752-7 liability partner is limited to that partner’s built-in loss in partnership interest at time of assumption
- One of the § 358(h) exceptions – the one relating to transfers of active business – applies in partnership situations under the regulations
- As with transfers to corporations, a transfer to a partnership of substantially all the assets related to a § 1.752-7 liability assumed by the partnership does not prevent the liability from being subject to the regime of Reg. §1.752-7
- *De minimis* exception for built-in losses on all §1.752-7 liabilities assumed by the partnership less than 10% of partnership’s gross assets, up to \$1 million

**Assumption of Contingent Obligations
in Tax-Free Transactions
Tax-Free Partnership Transfers
Current Regulations (Continued)**

- If §1.752-7 liability partner is separated from partnership interest and §1.752-7 liability (*e.g.*, in a sale or liquidation of partnership interest), regulations trigger reduction in partnership interest basis to eliminate any built-in loss resulting from assumption
 - Another parallel with taxable asset acquisitions: In determining amount of §1.752-7 liability to compute built-in loss and basis reduction, regulations “value” §1.752-7 liability at amount obligor would have to pay third party to assume liability (*James M. Pierce Corp. case*)
 - After the §1.752-7 liability partner is separated from the §1.752-7 liability, if partnership (or another partner) pays §1.752-7 liability, payor is not entitled to deduction or other tax benefit from the payment, to the extent of § 1.752-7 liability partner’s built-in loss not previously accounted for
 - Other partners do not suffer partnership interest basis reduction
 - Instead, payor is to notify §1.752-7 liability partner of payment, and that partner is entitled to deduction up to built-in loss
- Reg. §1.358-7 includes rules dealing with all “liabilities” (defined for this purpose by reference to §358(h)— similar to “obligation” in Reg. §1.752-7) assumed by partnership and then from the partnership by a corporation
- Preamble to proposed regulations pointed out that Reg. §1.752-7 concepts could find their way into corporate tax rules. Specifically, the definition of “liability” may find application for subchapter C purposes

Assumption of Contingent Obligations in Tax-Free Transactions Like-Kind Exchange

- If a taxpayer transfers property in a like-kind exchange, and the transferee assumes a liability or takes the property subject to a liability, the taxpayer has “boot,” as though it had received cash, and may recognize gain
- But, if the taxpayer also assumes a liability of the other party or takes the replacement property subject to a liability, the amounts of the liabilities are netted
- How do the rules work if the taxpayer’s transferred liability is contingent?
 - If the “value” of the transferred contingent liability can be determined, is it taken into account as boot—netted or not—at closing (“closed transaction” approach)?
 - If the “value” of the contingent liability cannot be determined, is the receipt of the boot deferred (“open transaction” approach)? If so, is the boot treated as a liability transfer and subject to netting, or as a receipt of cash and not subject to netting?
 - If the taxpayer had incurred the contingent liability in its acquisition of the transferred property, is the transfer of the liability excluded from amount realized (Reg. §1.1001-2(a)(3))?
 - If a taxpayer incurs a liability in an acquisition of property, and the liability is not reflected in the property basis, the transfer of the liability in a later sale of the property is excluded from amount realized. Reg. §1.1001-2(a)(3)
 - Does this rule apply to a like-kind exchange?
 - If so, does it matter if the acquisition was taxable (so that seller recognized gain from taxpayer’s assumption) or a tax-free (so that taxpayer assumed a pre-existing liability not reflected in the transferor’s basis)?

**Assumption of Contingent Obligations
in Tax-Free Transactions
Like-Kind Exchange (Cont'd)**

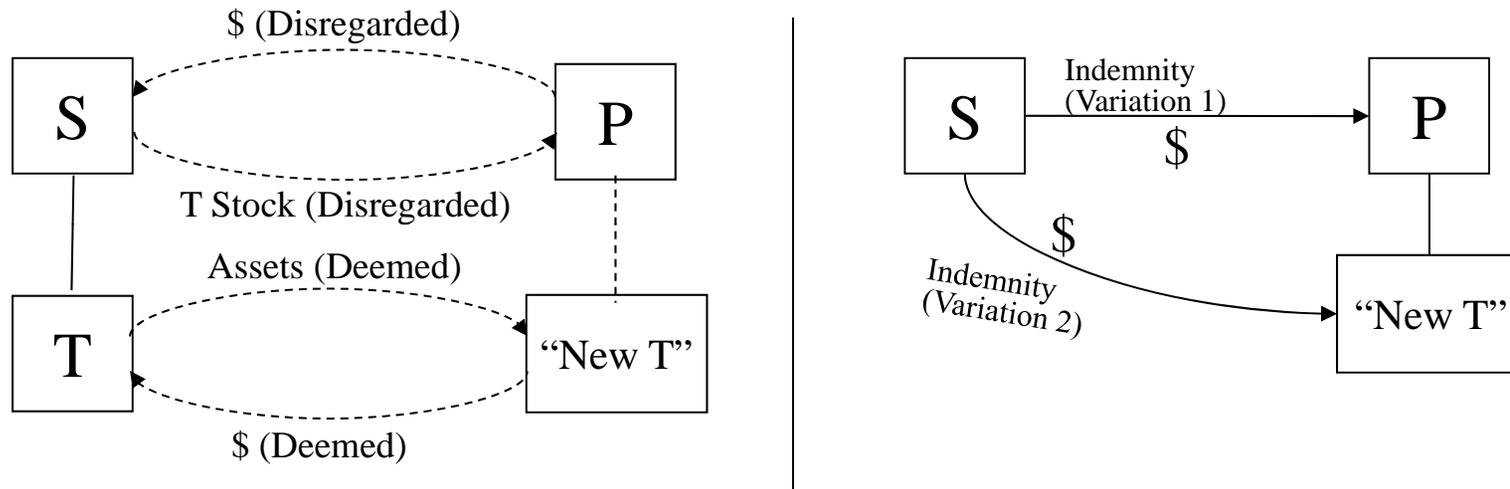
- How do the rules work if the taxpayer assumes a contingent liability with the replacement property or takes replacement property subject to a contingent liability?
 - Can the contingent liability be netted against a liability (contingent or not) that the taxpayer transfers to the other party with its transferred property?
 - If the taxpayer sells the replacement property subject to a contingent liability that the taxpayer assumed in the like-kind exchange, is the liability excluded from amount realized (Reg. §1.1001-2(a)(3))?

Indemnities of Contingent Obligations

Indemnities of Contingent Obligations

Asset Sale or §338(h)(10) Stock Sale

Discussion Problem—Facts



- S owns all the stock of T, which owns a manufacturing business
- S sells T stock to P for cash with §338(h)(10) election
 - At time of sale, T is defendant in patent infringement lawsuit
 - S agrees to indemnify P (Variation 1) or T (Variation 2) against an adverse judgment
 - Five years after closing, judgment is entered against T for damages plus interest back to three years before closing
 - S pays judgment

Indemnities of Contingent Obligations
Asset Sale or §338(h)(10) Stock Sale
Discussion Problem—Analysis

- If Seller indemnifies Buyer for a contingent obligation in an asset sale or a §338(h)(10) stock sale, no assumption of the obligation is considered to occur
- If accrual or payment of obligation is otherwise deductible, Seller is entitled to deduction when all-events and economic performance tests are met, as though no acquisition had occurred
- Buyer has no taxable income and no net effect basis of purchased assets (basis increase for payment of obligation and offsetting reduction for indemnity payment)

Flood v. United States, 133 F.2d 173 (1st Cir. 1943)

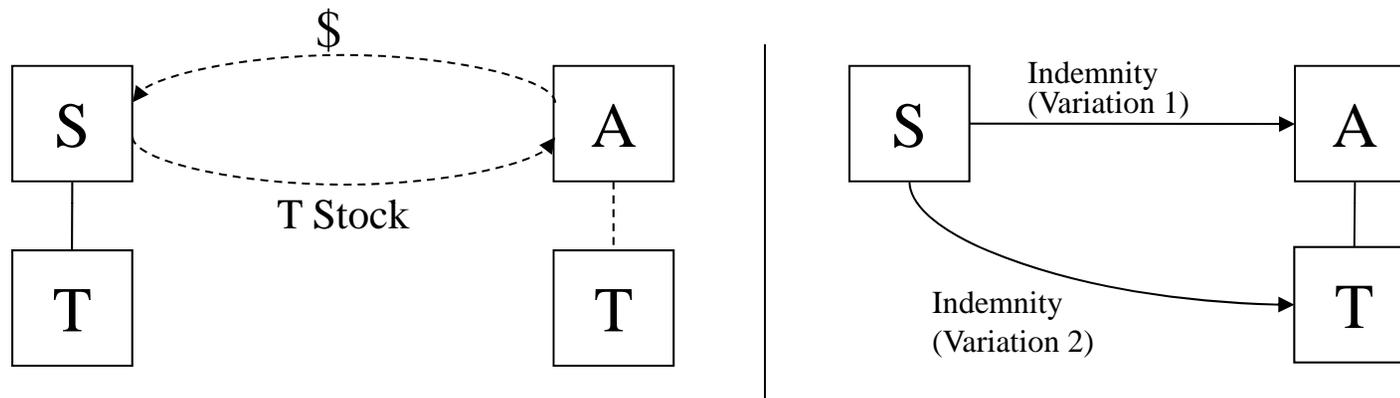
Shannonhouse Estate v. Commissioner, 21 T.C. 422 (1953)

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

Indemnities of Contingent Obligations

Stock Sale Without §338(h)(10)

Discussion Problem—Facts



- S owns all the stock of T, which owns a manufacturing business
- T is defendant in a patent infringement lawsuit
- S sells the T stock to A for cash with no §338(h)(10) election
 - S agrees to indemnify A (Variation 1) or T (Variation 2) against an adverse judgment
 - Five years after closing, judgment is entered against T for damages
 - S pays the judgment

Indemnities of Contingent Obligations Stock Sale Without §338(h)(10) Discussion Problem—Analysis

- If Seller indemnifies Buyer for Target's contingent obligation in a stock sale, Seller is deemed to contribute indemnity payment to Target's capital, relating back to immediately before sale
 - Result is retroactive increase in S's stock basis
 - Seller is entitled to capital loss when its indemnity obligation accrues, and there is economic performance
 - Target has no taxable income or gain
 - Target deducts or capitalizes (in accordance with tax accounting rules) Seller's payment, deemed paid by Target
 - No effect on Buyer's basis in Target stock
- Same analysis in tax-free reorganization

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

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

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

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

GCM 38977 (April 8, 1982)

Indemnities of Contingent Obligations

Stock Sale with §338(h)(10)

Insolvent Target

- Indemnity of contingent obligation by shareholder could make the difference between Target being solvent or insolvent
- If Target was insolvent before indemnity, and Seller and Buyer elect §338(h)(10), contribution (indemnity payment) and deemed liquidation are stepped together
 - Section 338(h)(10) election still applies
 - Buyer gets cost basis in assets deemed purchased
 - Deemed distribution does not qualify under §332
 - Taxable distribution of any unwanted Target assets
 - Target's loss carryovers and other tax attributes are eliminated
 - Worthless stock deduction for Seller (could be ordinary deduction if §165(g)(3) is satisfied)

Rev. Rul. 68-602, 1968-2 C.B. 135 (contribution of intercompany debt disqualifies pre-planned actual liquidation from §332)

CCA 200818005 (January 29, 2008) (contribution of intercompany debt in connection with stock sale disqualifies deemed liquidation under §338(h)(10) from §332)

Indemnities of Contingent Obligations
Tax-Free Reorganizations
Insolvent Target

- If Target is insolvent, and shareholder indemnifies Target for a contingent obligation in connection with a reorganization, step transaction doctrine does not apply
- Tax-free reorganization treatment still applies

Rev. Rul. 78-330, 1978-2 C.B. 147 (contribution of intercompany debt in connection with intra-group merger does not affect tax-free reorganization status of merger)

But see Prop. Reg. §1.368-1(e) (Target must have “net value” in reorganization)