

CONTINGENT CONSIDERATION AND CONTINGENT LIABILITIES IN ACQUISITIONS

REFERENCES

December 2011

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2012**

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

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TAXABLE ACQUISITIONS

TAXABLE ASSET AND STOCK ACQUISITIONS - CONTINGENT PURCHASE PRICE

Code Provisions

- Section 338(h)(10) (deemed asset sale on certain sales of stock with election)
- Section 453(a)(2), repealed (prohibition on installment method for accrual method taxpayers repealed retroactively in Pub. L. No. 106-170, § 536(c))¹
- Sections 453(f)(8), (j)(2) (treatment of contingent payments in installment sales)
- Section 468B(g) (regulation authority on taxation of income earned on amounts in escrow)
- Section 483(d)(4) (exception from OID and imputed interest requirements for transfers of patents)
- Section 1060(a) (allocation of consideration in sales of trade or business assets, for purposes of seller's gain and loss recognition and buyer's basis)

¹ The installment method was applied to contingent purchase price in the Installment Sale Revision Act of 1980. The use of the installment method by accrual method taxpayers was prohibited in 1999, but the prohibition was repealed retroactively in 2000 and never took effect. I.R.C. § 453(a)(2), Pub. L. No. 106-170, § 536(c) (106th Cong., 1st Sess. 1999) repealed by Installment Tax Correction Act of 2000, Pub. L. No. 106-573 (106th Cong., 2d Sess. 2000). K.S. Blanchard & T. Haythe, "Installment Method Repeal Makes No Sense At All," 86 Tax Notes 429 (Jan. 17, 2000), responding to L.A. Sheppard, "Installment Method Repealed for Whom?" 86 Tax Notes 8 (Jan. 3, 2000).

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

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

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

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

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

Legislative History

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

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

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

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

Current Regulations and Proposed Regulations

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

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

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

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

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

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

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

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

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

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

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

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

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

Reg. § 1.197-2(k) *Examples 5-10* (various rights as section 197 intangibles or not)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Reg. § 1.1275-4(c) (contingent payment debt instruments and OID outside “noncontingent bond method”)
- Prop. Reg. § 1.7872-2(b)(1)(iii) (deposit, *e.g.*, escrow, not treated as loan under below-market loan rules, if held in trust for transferor’s benefit)
- Prop. Reg. § 1.1001-1(j) (2006) (sale of property for annuity treated as sale under closed transaction method with amount realized equal to value of annuity determined under section 7520; Rev. Rul. 69-74 to be reversed)

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

- Reg. § 1.338(b)-3T(b) (definition of “contingent amount”)
- Reg. § 1.338(b)-3T(c) (contingent payments and contingent liabilities taken into account when they become “fixed and determinable,” by both deemed buyer and deemed seller under sections 338(g) and 338(h)(10), in determining AGUB and asset basis; reductions of consideration or liabilities taken into account when the reduction “occurs”)
- Reg. § 1.338(b)-3T(d) (FMV limitation for allocations to asset classes determined on the acquisition date and not adjusted later)
- Reg. § 1.338(b)-3T(e) (decreases in AGUB allocated to asset classes in reverse order)
- Reg. § 1.338(b)-3T(g) (special allocation of consideration to contingent income assets; *see Associated Patentees* and section 197 regulations – eliminated in new temporary and final regulations (64 Fed. Reg. 43461 at 43470))
- Reg. § 1.338(b)-3T(h) (contingent payments and contingent liabilities under section 338(h)(10), seller side)
- Reg. § 1.338(b)-3T(j) Examples (3), (4) (contingent payment under section 338(g) and 338(h)(10), buyer side (AGUB))
- Reg. § 1.1060-1T(f)(1) (increase or decrease in consideration taken into account by both buyer and seller “under applicable principles of tax law”)
- Reg. § 1.1060-1T(f)(2) (FMV limitation for allocations to asset classes determined on acquisition date and not adjusted later)
- Reg. § 1.1060-1T(f)(4) (allocation of consideration to contingent income assets; *see Associated Patentees* and section 197 regulations – eliminated in new temporary and final regulations; *see* 64 Fed. Reg. 43461 at 43470)

Court Decisions

- Burnet v. Logan*, 283 U.S. 404 (1931) (open transaction treatment of contingent payment in stock purchase; basis to be recovered fully before gain reported)
- Burnet v. Harmel*, 287 U.S. 103, 106 (1932) (capital gain treatment only for “situations typically involving the realization of appreciation in value accrued over a substantial period of time)
- Fairbanks v. United States*, 306 U.S. 436 (1939) (overturned) (a redemption by a borrower of its won debt instrument is not a sale or exchange).
- Hort v. Commissioner*, 313 U.S. 28 (1941) (surrender of lease by tenants to landlords for cash results in ordinary income for landlords because payments replace what would have been ordinary income from rent)
- Rhode’s Est. v. Commissioner*, 131 F2d 50 (6th Cir. 1942) (sale of right to declared but unpaid dividends yields ordinary income)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963) (if goodwill exists, capital gain or loss treatment is more likely)

Lowe v. Commissioner, 44 T.C. 363 (1965) (initial down payment that Seller received from stock sale *held* capital gain under *Arrowsmith* despite fact that Seller retained possession of stock and later retook control of corporation)

Maryland Coal & Coke Co. v. McGinness, 350 F.2d 293 (3d Cir. 1965) (sale of right to sell output of a mine yields ordinary income)

Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965) (taxpayer erroneously used open transaction method for a fixed-amount note, on accountant's advice; IRS disallowed open transaction method, and taxpayer elected installment method after the fact; *Held*, IRS could not refuse to allow taxpayer to elect installment method (distinguishing *Pacific Nat. Co. v. Welch*, 304 U.S. 191 (1938), in which original method was permissible))

Bellamy v. Commissioner, 43 T.C. 487 (1965) (lack of taxpayer investment *held* to suggest ordinary income treatment)

Wingate v. Commissioner, 45 T.C. 489 (1966) (cash method taxpayer acquired mortgages at discount and made collections thereon; *held*, because mortgages were "speculative," taxpayer could recover his full basis before reporting any income)

Lozoff v. U.S., 266 F. Supp. 966 (E.D. Wis. 1967) (sale of right to act as purchasing agent yields ordinary income)

Dorsey v. Commissioner, 49 T.C. 606 (1966) (corporate liquidation in which shareholders received contractual right to share of receipts from new automatic pinsetting equipment was open transaction, and amounts received were capital gain from liquidation; new and untried business model for bowling industry decisive (*Arrowsmith* not cited))

Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967) (stock-for cash-acquisition with covenant not to compete; values assigned to stock price and consideration for covenant in contract; *held*, in absence of proof of fraud, misrepresentation, duress or other reason to void contract, parties are bound by agreed form; only Service may challenge)

Bankers Guarantee Title & Trust Co. v. United States, 418 F.2d 1084 (6th Cir. 1969) (if goodwill exists, capital gain or loss treatment is more likely)

Siple v. Commissioner, 54 T.C. 1 (1970) (purchasers of stock denied ordinary loss and allowed capital loss for payments to bank to redeem collateral pledged on behalf of corporation; payments to bank were part of the original cost of acquiring stock)

Schmidt v. Commissioner, 55 T.C. 335 (1970) (after partial liquidation, shareholder claimed long-term capital loss for excess of stock basis over the FMV of remaining assets; shareholder held not entitled to a loss until liquidation was complete)

Billy Rose's Diamond Horseshoe, Inc. v. Commissioner, 448 F.2d 549 (2d Cir. 1971) (release of contract right to repair leased premises not a sale)

MacDonald v. Commissioner, 55 T.C. 840 (1971) (license of new hardboard manufacturing process for royalty payments taxed as sale and open transaction; royalty payments treated as basis recovery and then capital gain; earlier licenses were different enough from license at issue so that value could not be based on history)

Estate of Shea, 57 T.C. 15 (1971) (gain from disposition of a shipping charter gave rise to capital gain, partially because the value of the charter fluctuated with market forces)

Flower v. Commissioner, 61 T.C. 140 (1973) (sale of right to promote pharmaceutical products yields ordinary income)

Holden Fuel Oil Co. v. Commissioner, T.C. Memo 1972-45, *aff'd* 479 F.2d 613 (6th Cir. 1973) (contingent payments to purchase customer list held deductible as made, under *Associated Patentees*)

In re Steen v. United States, 509 F.2d 1398 (9th Cir. 1975) (in sale of uranium mine for share of profits, Buyer agreed to pay added purchase price if open state tax issue was favorably resolved; *held*, obligation to pay share of profits had FMV at time of sale, but state tax contingency payment had no FMV at that time because state tax issue was novel; sale treated as partly-closed transaction)

Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973) (cash method taxpayer sold apartment building for cash and contract obligation to make payments with bullet after 15 years; contract could be transferred only at substantial discount; based on history of §1001 and enactment of §453, "cash equivalent" test for gain realization applied by Tax Court rejected; transaction closed, and amount realized on sale measured by reference to FMV of contract)

Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978) (taxpayer's surrender of stock in satisfaction of warranty of corporation's net worth given to induce third party to invest in corporation was capital not ordinary loss; main reason for warranting corporation's net worth was to receive future option to buy more shares; warranty agreement was a sale transaction of which surrender of stock was an integrated part)

Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978) (offsetting put and call options on stock not treated as current sale of stock)

Estate of Wiggins v. Commissioner, 72 T.C. 701 (1979) (real estate developer sold lots for future payments under contract with no mortgage or other security and other contingencies; open transaction treatment allowed; taxpayer could recover basis before recognizing any taxable gain or income (including interest))

Monarch Cement Co. v. United States, 634 F.2d 484 (10th Cir. 1980) *aff'g* 458 F. Supp. 384 (D. Kan. 1978) (stock warrants issued in connection with a note was discount amortizable over the term of a loan; warrants valued at time of loan)

Campbell v. United States, 661 F.2d 209 (Ct. Cl. 1981) (taxpayer sold stock of corporation in exchange for cash and stock and securities of Acquiror; thereafter, Acquiror suffered reversals, and FMV of its stock and securities declined; *held*, sale transaction closed, and amount realized based on traded value of stock and securities at time of sale; hindsight not taken into account)

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

Foy v. Commissioner, 84 T.C. 50 (1985) (taxpayer created a network of janitorial franchises and, for a share of revenue, guaranteed a certain level of sales. This right was a capital asset due to assumption of risk in guaranteeing sales and level of personal involvement)

Centel Communications v. Commissioner, 920 F.2d 1335 (7th Cir. 1990) (stock warrants issued to shareholders in recognition of loan guarantees were not transferred in connection with services under § 83; issuer not entitled to deduction, shareholders did not have ordinary income on exercise)

Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1993-467 (1993) (stock warrants issued as a purchase incentive were purchase price discounts; the warrants did not have to be capitalized)

T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993) (taxpayer may deduct amount paid solely to reduce or eliminate future costs)

Convergent Technologies v. Commissioner, T.C. Memo 1995-320 (1995) (stock warrants issued as a purchase incentive were purchase price discounts; the warrants did not have to be capitalized; warrants should be valued at exercise)

Computervision Int'l Corp. v. Commissioner, T.C. Memo 1996-131 (1996), *vacated on other grounds*, 164 F.3d 73 (1st Cir. 1999) (stock warrant issued as a purchase incentive qualified as a trade discount)

Wolff v. Commissioner, 148 F.3d 186 (2d Cir. 1998) (cited by IRS for proposition that extinguishment doctrine still valid, but facts occurred before passage of 1234A)

ACM Partnership v. Commissioner, T.C. Memo. 1997-115, *aff'd* 157 F.3d 231 (3d Cir. 1998) (installment sale contingent payment regulations resulting in loss not followed; transaction disregarded as lacking economic substance)

Spencer v. Commissioner, 110 T.C. 62 (1998) (redetermination of property basis results in adjustments to depreciation deductions for remainder of property life; *see* cases cited therein)

Nahey v. Commissioner, 111 T.C. 256 (1998), *aff'd*, 196 F.3d 866 (7th Cir. 1999) (taxpayer bought assets of a business that included a claim in a pending lawsuit involving lost income, and later settled suit at a gain. Court held settlement proceeds were ordinary income to buyer, rather than capital gain. Cited by IRS for support of extinguishment doctrine, but this seems a stretch)

ASA Investerings Partnership v. Commissioner, T.C. Memo 1998-305, *aff'd* 201 F.3d 505 (D.C. Cir. 2000) (ACM-type contingent installment sale transaction established a debtor-creditor relationship, not a partnership)

Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (1999) (ACM-type contingent installment sale transaction disregarded as lacking economic substance and a sham)

Mann Const. Co. v. Commissioner, T.C. Memo. 1999-183 (no ordinary bad debt deduction under section 166 for contingent debt)

Custom Chrome Corp. v. Commissioner, 217 F.3d 1117 (9th Cir. 2000); *aff'g in part and rev'g in part*, T.C. Memo. 1998-317 (1998) (stock warrants issued in connection with a LBO transaction was discount amortizable over the term of a loan; warrants valued at time of loan)

Seagate Technology, Inc. v. Commissioner, T.C. Memo. 2000-361 (foreign subsidiary's sale of restricted third-party stock received as consideration for asset sale to third party treated

as gain from sale of passive investment in stock, thus generating foreign personal holding company income under section 954(c); stock sale not treated as gain from the earlier asset sale since relation-back doctrine of *Arrowsmith* does not apply; open transaction treatment does not apply to asset sale)

Patton Trust v. United States, 2001-1 U.S. T.C. ¶50,332, AFTR 2d 1587 (Ct. Cl. 2001) (fair market value of note at time of transaction was face value; installment sale not open transaction method was proper way to report income; subsequent change in note's value irrelevant)

Boca Investings Partnership v. United States, 314 F.2d 625 (D.C. Cir. 2003) (ACM-type contingent installment sale transaction disregarded, because no business purpose for partnership set up to make the sale)

Andantech, L.L.C., v. Commissioner, 331 F.3d 972, (D.C. Cir. 2003) (similar to *ASA Investorings*)

United States v. Culp, 99 AFTR 2d 2007-618 (M.D. Tenn. 2006) (in sale of Ernst & Young consulting business, consulting partners received Acquiror stock in escrow, subject to forfeiture, and stock declined in value thereafter; *held*, partners taxed at closing on receipt of stock, not mere contingent interests in stock received later at depreciated value, because partners were contractually bound under *Danielson*; same transaction and same result as in *Berry, Fletcher, Bergbauer, Nackel, Fort and Hartman*)

Hightower v. Commissioner, T.C. Memo 2005-274, *aff'd unpub. op.*, 101 AFTR 2008-836 (9th Cir. 2008) (cash method taxpayer recognized gain on sale of stock on receipt of cash proceeds, even though validity of sale contested in later litigation)

United States v. Berry, 2008-2 USTC ¶ 50590 (D. N.H. 2008) (same transaction and same result as in *Culp, Fletcher, Bergbauer, Nackel, Fort and Hartman*; decision based on *Danielson*)

United States v. Fletcher, 562 F.3d 839 (7th Cir. 2009), *aff'g* 101 AFTR 2d 2008-588 (N.D. Ill. 2008) (same transaction and same result as in *Culp, Berry, Bergbauer, Nackel, Fort and Hartman*; decision on merits, not based on *Danielson*)

Fisher v. United States, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Ct. Fed. Cl. 2008) *aff'd without opinion*, 2009 WL 3241381 (Fed. Cir. 2009) (on demutualization of life insurance company, policyholder who retained his policy and received cash in lieu of stock for his equity interest could recover his full cost basis in his policy before recognizing gain; under open transaction principles, basis could not be allocated between policy and equity interest in mutual company, because there was no reasonable basis for allocation; default allocation of zero basis to equity interest, which would have led to gain on full amount of cash received, rejected)

Katz v. Commissioner, T.C. Memo. 2008-269 (after receiving stock in tax-free acquisitive reorganization, taxpayer entered into equity swap by buying put and selling call in stock and then sold stock and put for private annuity; purchaser sold stock; *held*, form of private annuity respected, and tax on gain deferred under Rev. Rul. 69-74)

United States v. Nackel, 686 F.Supp.1008 (C.D. Cal. 2009) (same transaction and same result as in *Culp, Berry, Fletcher, Bergbauer, Fort and Hartman* with decision on merits; forfeiture of escrowed stock *held* unlikely)

Anschutz Co. v. Commissioner, 132 T.C. No. 5 (2010) (prepaid forward contract for sale of publicly-traded stock for cash (80% of stock's FMV) and agreement to lend the same stock treated as current sale of stock; cash loan proceeds treated as amount realized; taxpayer

retained rights to dividends and benefit of appreciation beyond fixed amount; IRS argued that these rights were additional sale price in closed transaction, but court did not include these benefits in amount realized and apparently treated them as additional price to be paid in open transaction)

United States v. Bergbauer, 602 F.3d 569 (4th Cir. 2010) (same transaction and same result as in *Culp, Berry, Fletcher, Fort, Nackel* and *Hartman* with decision based mainly on *Danielson*)

United States v. Fort, 107 AFTR 2d 2011-1873 (11th Cir. 2011), *aff'g* 105 AFTR 2d 2010-2559 (D. Ga. 2008) (same transaction and same result as in *Culp, Berry, Fletcher, Bergbauer, Nackel* and *Hartman*, with decision on merits; forfeiture of escrowed stock found unlikely)

Hartman v. United States, 107 AFTR 2d 2011-2244 (Ct. Fed. Cl. May 13, 2011) (same transaction and same result as in *Culp, Berry, Fletcher, Bergbauer, Fort* and *Nackel*, with decision on merits, following *Fletcher* and *Fort*)

Samueli v. Commissioner, 108 AFTR 2d 2011-6270 (9th Cir. Sept. 15, 2011, *amended on rehearing* Nov. 1, 2011) (receipt of payment in fulfillment of payor's contractual obligation to deliver securities not "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of...a right or obligation...with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" under section 1234A; thus, receipt could be short-term, not long-term, capital gain from prior sale of securities)

Revenue Rulings and Notices

Rev. Rul. 58-402, 1958-2 C.B. 15 (contracts and claims to receive indefinite amounts, such as those received in corporate liquidation, must be valued for tax purposes except in rare and extraordinary cases)

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

Rev. Rul. 69-74, 1969-1 C.B. 43 (in sale of property by individual at a gain for private annuity on seller's life, gain realized on difference between present value of annuity, based on annuitant's life expectancy, and property basis; gain deferred and taxed ratably over life expectancy; to be reversed by Prop. Reg. § 1.1001-1(j) (2006))

Rev. Rul. 76-527, 1975-2 C.B. 30 (no sale, and so no capital gain, upon release of a right to heat a building, because right was extinguished rather than "passed" to another party)

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

Rev. Rul. 77-294, 1977-2 C.B. 173, *revoking* Rev. Rul. 68-246, 1968-1 C.B. 198 (installment sale agreement changed in year of sale to place purchase price in escrow without substantial restriction on seller's right to receive escrowed funds; installment method not available)

Rev. Rul. 79-278, 1979-2 C.B. 302 (Acquiror bought Target stock from Seller and sold it at short-term capital loss; Seller paid damages to Target under court-ordered settlement for securities law violations; under *Arrowsmith*, payment is short-term capital gain to Acquiror, reported in year court approves settlement)

Rev. Rul. 85-87, 1985-1 C.B. 268 (sale of stock at a loss coupled with sale of “in-the-money” put on stock; put treated as contract to acquire the stock and caused loss to be disallowed under wash sale rules)

Rev. Rul. 87-63, 1987-2 C.B. 210 (payments under commodity trading franchise license agreement not subject to section 1253(d) but deductible upon economic performance)

Rev. Rul. 88-24, 1988-1 C.B. 306 (on sale of franchise business subject to rights of original franchisee, buyer may amortize amount allocable, under section 1060, to purchased franchise rights, as provided in section 1253(d), even though transaction is sale of a capital asset)

Notice 90-56, 1990-2 C.B. 344 (installment sale regulations to be revised to prevent inappropriate deferral of basis recovery)

Rev. Rul. 2002-31, 2002-1 C.B. 1023 (convertible zero-coupon debt with contingent interest – payable if instrument increases in FMV – results in interest deductions under “contingent bond method”; section 163(l) (disallowing deductions for interest payable in stock) not applicable; section 249 (disallowing deduction for redemption premium based on conversion feature) not applicable to periodic interest deductions; *see also* Notice 2002-36, 2002-1 C.B. 1029)

Notice 2008-2, 2008-2 I.R.B. 252 (request for comments as to whether parties to a prepaid forward contracts, exchange traded notes and other financial instruments not classified as debt should be required to accrue income/expense during the term of the transaction, and related issues)

Chief Counsel Guidance

GCM 37073 (Mar. 31, 1977) and cases cited therein (accrual method contractor taxed currently on cash transferred to custodian pending contractor’s performance under contract if contractor has investment power or power to substitute securities for cash—“dominion and control” theory, not “constructive receipt” or “economic benefit”)

PLR 8217183 (Jan. 29, 1982), *supplemented*, PLR 8221081 (Feb. 25, 1982) (parent sold stock of subsidiary which had a contingent claim against it; buyer agreed to pay additional cash if claim proved to be less than specified amount; based on cash sale price and estimate of additional payment, total consideration was less than parent’s stock basis; IRS rules that, if transaction is “closed,” parent may claim loss in year of sale based on cash price plus fair market value of additional payment, but, if transaction is open, loss may not be realized until later)

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

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

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

PLR 8645029 (Aug. 8, 1986) (similar to PLR 8629038)

TAM 9737001 (May 23, 1997) (warrants issued to cable companies in connection with affiliation agreements providing channel access warrants were not granted in connection with services, but as an inducement to obtain more channel access; § 83 does not apply).

PLR 9743034 (July 28, 1997) and PLR 9743035 (July 28, 1997), *revoking* PLR 9211029 (Dec. 13, 1991) (CPA’s negligence caused fund not to qualify as RIC and increased fund’s

tax liability; insurance carrier reimbursed fund for tax, penalties and interest; reimbursement taxable income to fund because payment of actual tax liability; would not be income if advice had caused fund to pay more than its actual tax liability)

TAM 9840001 (Oct. 2, 1998) (contingent payment right not debt where obligation to make payments entirely dependent on ability to collect payment from third parties with very poor credit ratings, and payments due only on amount remaining after collection costs and servicing fees)

PLR 984006 (Oct. 16, 1998) (allows ordinary deduction for public utility that buys out contract right of Qualified Facility under PURPA, but mentions neither 1234A or extinguishment doctrine)

PLR 19913032 (April 5, 1999) (allows ordinary deduction for public utility that buys out contract right of Qualified Facility under PURPA, but mentions neither 1234A or extinguishment doctrine)

FSA 199941001 (Feb. 2, 1999) (Seller using the fair market value of contingent payment right calculated gain correctly but maximum amount might have been appropriate)

TAM 200043013 (Oct. 30, 2000) (warrants issued to lending bank in bankruptcy reorganization of borrower not transferred in connection with services performed by bank; if warrants have value at time of issuance, there is OID on loan deductible over life of loan)

PLR 200045019 (Aug. 10, 2000) (receipt of payment to terminate a rent controlled lease capital gain on sale of leasehold interest)

TAM 200049009 (Aug. 9, 2000) (Qualified Facility under PURPA receives ordinary income from sale to public utility of right to sell its output — adopts extinguishment doctrine)

PLR 200051033 (Sept. 25, 2000) (allows ordinary deduction for public utility that buys out contract right of Qualified Facility under PURPA, but mentions neither 1234A or extinguishment doctrine)

PLR 200051035 (Sept. 26, 2000) (allows ordinary deduction for public utility that buys out contract right of Qualified Facility under PURPA, but mentions neither 1234A or extinguishment doctrine)

PLR 200052010 (Jan. 2, 2001) (amounts paid to terminate a burdensome fuel transportation treated as ordinary loss, not as capital loss under section 1234A)

PLR 200130002 (July 27, 2001) (sale of rights to license and distribute a popular television talk show was sale of capital asset)

PLR 200215037 (Jan. 14, 2002) (Qualified Facility's bundle of contract rights under PURPA is a capital asset in part because the profit or loss derived therefrom depends on the fluctuating market price of electricity)

PLR 200345020 (Nov. 7, 2003) (installment sale with contingent purchase price approved for alternative accelerated basis recovery)

TAM 200346007 (Nov. 14, 2003) (sale-leaseback at less than FMV can qualify as sale, but basis will be adjusted to FMV; resembles installment sale.)

TAM 200427025 (Dec. 9, 2003) (receipt of payment to cancel contract for purchase of electric power ordinary income; section 1234A not applicable, because payment was substitute for ordinary income that taxpayer would have realized from sales)

CCA 200423028 (March 30, 2004) (lottery winner sold winning ticket for contingent installment note with payments based in part on investment of lottery proceeds as directed by seller; installment method allowed)

FAA 20042304F (June 4, 2004) (taxpayer issued its warrants to customer as part of customer's agreement to allow taxpayer to operate customer's data center; no income exclusion or deduction for the warrants allowed; *Sun Microsystems* and *Convergent Technologies* distinguished, because (1) customer exercised the warrants, (2) warrants not tied to any quantity of services purchased by customer, and (3) no intent documented to treat issuance of warrants as a discount)

TAM 200452033 (Sept. 27, 2004) (amounts received on policy holder's termination of life insurance policies taxed as ordinary income to extent attributable to inside buildup; section 1234A not applicable)

PLR 200603017 (Oct. 7, 2005) (earn-out payment with no cap on stock sale; under installment method, IRS grants alternative basis recovery based on estimated earn-out payments)

Generic Legal Mem. 2007-4 ("backwards" contingent sale: Seller receives \$1600 at closing and agrees to deliver a number of shares of stock contingent on traded price on a future date; Seller pledged maximum number of shares to escrow, which loaned them to Purchaser; transaction treated as immediate sale of Seller's stock; Rev. Rul. 2003-7, 2003-1 C.B. 363, distinguished because of securities loan)

LAFB 20080101F (Dec. 3 2007) (purported sale for contingent purchase price not a sale for tax purposes under economic substance doctrine, but, if a sale, installment method does not apply separately to each class of assets under section 1060 (citing this outline); imputed interest under section 483 must be computed; and deferral charge applies)

PLR 201027035 (Mar. 31, 2010) (as part of consideration in section 338(h)(10) stock sale, Seller received right to a percentage of tax benefit New T obtained from stepped-up basis in deemed purchased assets; Seller assigned part of its rights to Y, and New T settled its obligations for a fixed cash payment to Y; *ruled* New T did not realize cancellation-of-debt income)

PLR 201043009 (July 21, 2010) (same as PLRs 201043010 – 201043014) (foreign government expropriated stock in corporation through series of steps culminating in squeeze-out of taxpayers' stock; taxpayers received cash for their stock in amount less than basis. taxpayers sued in foreign country court to obtain return of their stock but represented that they had "no reasonable prospect of recovering" their stock in court; *ruled*, pending lawsuit does not prevent loss from being recognized at time of expropriation)

Commentary

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S. Land, "Contingent Payments and the Time Value of Money," 40 Tax Lawyer 237 (1987)

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- D. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 American Journal of Tax Policy 17 (1998)
- L. Sheppard, "Installment Method Repealed for Whom?" 86 Tax Notes 8 (Jan. 3, 2000)
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- R. Bailine, "KPMG Asks for Guidance on Contingent Payments Following a Stock Purchase Treated As an Asset Purchase," 2000 Tax Notes Today 97-19 (May 18, 2000)
- Corporate Acquisition Ideas, "IRS Issues New Guidance on the Use of the Installment Sale Method of Accounting" Corporate Acquisitions, Mergers, and Divestitures, June 2000
- R. Flinn, "Does Installment Sale Rule Change Make Stock Sales a More Attractive Means of Structuring Sale of Smaller C Corporations?" 78 TAXES 31 (July 2000)
- E. Sair et. al., "Treatment of Contingent Obligations in Stock or Asset Sales Uncertain After Repeal of Installment Method of Reporting for Accrual Method Taxpayers," J. Corp. Tax'n 203 (Autumn 2000)
- E. Seago, "A Modest Proposal Regarding the Matching Principle," 90 Tax Notes 1855 (2001)
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- M. Baillif, "Sales Price Adjustments: The Continuing Conundrum," 57 Tax Lawyer 571 (2004)
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- J. Cummings, "TAM 200427025 Raises Questions on How Little-Known Statutory Change Affects Abandonments of Property," Corporate Tax Insights on Checkpoint (July 13, 2004)
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TAXABLE ASSET AND STOCK ACQUISITIONS - ESCROWS

Code Provision

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

Legislative History

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II-845 n2 (1986) (section 468B(g) intended to “reverse the finding in Rev. Rul. 71-119,” which implied no current tax on escrow income)

Proposed Regulations

Prop. Reg. § 1.468B-8 (income earned on “contingent at-closing escrows” on sales of trade or business taxed to purchaser who provided the funds, regardless of which party is the owner under general tax principles)

Prop. Reg. § 1.468B-9 (income earned on “disputed ownership funds” under court jurisdiction taxed on the fund as a separate entity like a “qualified settlement fund” (*see also* Reg. § 1.468B-1, allowing grantor of qualified settlement fund to elect to be taxed on fund income))

Court Decisions

Bonham v. Commissioner, 89 F.2d 725 (8th Cir. 1937) (Acquiror stock received by Seller in taxable exchange and transferred to escrow to secure Seller’s obligations; stock would be sold and applied to compensate Acquiror for Seller breach; *held*, stock taxable as sale proceeds to Seller despite escrow)

Chaplin v. Commissioner, 136 F.2d 298 (9th Cir. 1943) (Filmmaker received stock placed in escrow pending his future delivery of five photoplays, but filmmaker had rights to vote and to receive dividends; *held*, stock taxable to filmmaker despite escrow)

Brown v. Commissioner, 10 B.T.A. 1036 (1928) (Seller, shareholder-employee of Target, wishing to induce Acquiror to buy remaining Target stock from estate, promised to pay Acquiror part of back salary Target might pay to Seller; payment *held* reduction in Acquiror’s purchase price for Target stock, not income to Acquiror)

North American Oil Consol. v. Burnet, 286 U.S. 417 (1932) (income earned on property *held* in receivership pending determination of owner; *held*, not taxable to accrual-basis owner taxable in year earned, but in year turned over)

Steckel Estate v. Commissioner, 253 F.2d 267 (6th Cir. 1958), *aff'g per curiam*, 26 T.C. 600 (1956) (payment for taxpayer's stock *held* by court pending resolution of suit against taxpayer income in year of payment)

Commissioner v. Hansen, 360 U.S. 446 (1959) (automobile dealer reserve accounts that only could benefit dealer in one form or another; *held*, taxable to dealer when amounts credited to accounts)

Anderson v. Commissioner, 20 T.C.M. 697 (1961) (Target recognizes no income when Acquiror places funds in escrow to against possible breach of warranty for undisclosed corporate liabilities)

Oden v. Commissioner, 56 T.C. 569 (1971) (Deposit of funds into escrow by purchaser of property results in constructive receipt by seller, if seller's right to receive the funds is not subject to substantial restriction other than time of payment)

Freedom Newspapers, Inc. v. Commissioner, T.C. Memo 1977-429 (Acquiror purchased four newspapers, including one unwanted newspaper; broker agreed to find buyer for unwanted newspaper or pay cash amount; buyer not found, and cash payment made by broker; unwanted newspaper sold later; cash payment *held* reduction in purchase price for unwanted newspaper, not liquidated damages for failure to sell the unwanted newspaper, thus reduced capital loss on sale of unwanted newspaper, not ordinary income to purchaser)

Stiles v. Commissioner, 69 T.C. 558 (1978), *acq.* 1978-2 C.B. 3 (Deposit of funds into escrow by purchaser of property does not result in constructive receipt to seller, if seller's right to escrowed funds is subject to substantial restriction or condition)

Johnson v. Commissioner, 108 T.C. 448 (1997) (automobile dealers sold multi-year service contracts and placed in escrow a portion of proceeds to fund obligations; *held*, dealers own accounts and must currently include investment income under section 468B(g))

Ahadpour v. Commissioner, T. C. Memo 1999-9 (1999), *acq. in result only*, AOD 2000-002, 2000-1 C.B. ix (escrow payments received by seller not taxable while escrow period remained open because seller obligated to repay amounts if escrow did not close; IRS acquiesced in result only that escrow payments received by seller not taxable; for non-real estate dealers, escrow payments not treated as deposits)

Revenue Rulings

Rev. Rul. 77-294, 1977-2 C.B. 173 (escrow imposing substantial restriction on seller's right to receive sales proceeds eligible for installment method)

Rev. Rul. 79-91, 1979-1 C.B. 179 (six-year payment schedule is not a substantial restriction on seller's right to receive sale proceeds; installment method not available on sale)

Rev. Rul. 87-127, 1987-2, C.B. 156 (income earned by pre-need funeral trust generally taxed to purchaser of pre-need funeral; *see* I.R.C. § 685)

Rev. Rul. 92-51, 1992-2 C.B. 102, *obsoleting* Rev. Rul. 71-119, 1971-1 C.B. 163 (court controlled fund not taxable grantor trust), Rev. Rul. 70-567, 1970-2 C.B. 133 (interest accumulated in escrow taxable upon distribution) and Rev. Rul. 64-131, 1964-1 C.B. Part 1 485 (third situation: income on funds held in anticipation of settling litigation taxable upon distribution)

Chief Counsel Guidance

- GCM 37073 (March 31, 1977) (accrual method contractor taxed currently on cash transferred to custodian pending contractor's performance under contract if contractor has investment power or power to substitute securities for cash—"dominion and control" theory, not "constructive receipt" or "economic benefit")
- PLR 9243033 (July 24, 1992) (income on state-established escrow (on behalf of several counties) pending court decision on validity of imposition of use tax; *held*, taxable)
- PLR 9228020 (Apr. 10, 1992) (income on SEC-controlled escrow accounts; *held*, not taxable because accounts established before effective date of section 468B(g))
- PLR 199949041 (Sept. 13, 1999) (contingent payment asset sale under installment method; IRS allows alternative basis recovery under Temp. Reg. § 15a.453-1 (c)(7))
- PLR 200521007 (Feb. 25, 2005) (on S corporation asset sale, part of sale price escrowed against seller indemnity for breach of warranty, covenant or representation; installment method not used, because accountant advised not available; IRS rules installment method available because of substantial conditions in escrow, and consents to revocation of election out of installment method)
- PLR 200714007 (Jan. 8, 2007) (IRS "will not challenge" application by taxpayer of Prop. Reg. § 1.468B-9 to escrow established before effective date of final regulation based thereon)

Commentary

- R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981)
- Report on the Taxation of Escrow Accounts, Committee on Personal Income Tax of the Bar of the City of New York, Dec. 26, 1990, 90 TNT 264-43 (recommending rules under which buyer generally is taxable on income generated by escrow)
- Proposal on the Taxation of Escrow and Settlement Funds under I.R.C. Section 468B(g), County of L.A. Bar Association Section of Taxation, May 4, 1991 (91 TNT 127-63) (depositor taxed on income unless transfer meets economic performance, in which case fund taxed)
- Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed by Section 468B(g) of the Internal Revenue Code, New York State Bar Association Tax Section, July 20, 1992, 92 TNT 156-31 (escrows generally should be treated as grantor trusts with buyer as grantor)
- J.L. Cummings, "The tax-free cash-out reorganization—Eugene A. Fisher et al. v. U.S. (Ct. Fed. Cl. 8/6/2008) 102 AFTR 2d ¶ 2008-5150," Commentary from: Corporate Tax Insights on Checkpoint (Aug. 11, 2008)
- R. Willens, "With 'Fisher' Ruling, Open Transaction Doctrine Lives," 162 DTR J-1 (Aug. 21, 2008)

TAXABLE ASSET ACQUISITIONS – CONTINGENT LIABILITIES AND INDEMNITIES

Code Provisions

- Section 338(h)(10) (deemed asset sale on certain sales of stock with election)
- Section 404(a)(5) (deferred compensation deductible by employer in year with or within which ends year in which income is includible by employee; *see* section 83(h))
- Section 455(a) (deferral of prepaid subscription income)

Section 456(a) (deferral of prepaid club dues)
Section 461(h) (economic performance required for certain accruals)
Section 1060(a) (allocation of consideration in sales of trade or business assets, for purposes of seller's gain and loss recognition and buyer's basis)
Section 1274(c)(4) (exception from imputed interest requirement for liability assumptions on property sales)

Current Regulations and Preamble

Reg. § 1.338-4(d) (for ADSP purposes, contingent liabilities taken into account as though there had been an actual asset sale)
Reg. § 1.338-5(b)(2)(iii) *Example 2* (assumed environmental liability)
Reg. § 1.338-5(e)(2) (for AGUB purposes, contingent liabilities taken into account as though there had been an actual asset sale)
Reg. § 1.338-6(c)(5) (special treatment of nonqualified funds transferred in connection with sales of nuclear power plants; buyer may elect to treat qualified fund as a corporation whose stock is purchased with a section 338(h)(10) election)
Reg. § 1.338-11 (application of section 338 to taxable asset acquisitions of insurance companies, including "assumption-reinsurance" transactions)
Reg. § 1.446-1(c)(1)(ii) (contingent liabilities not included in basis)
Reg. § 1.461-1(a)(2)(i) (economic performance required for inclusion in basis of purchased property)
Reg. §§ 1.461-1(a)(2)(iii)(D), 1.461-4(d)(2)(iii) (except as otherwise provided, economic performance of obligation to pay employee benefits incurred when deductible under special statutory rules, but treatment under section 83 reserved)
Reg. § 1.461-4(d)(5) (economic performance occurs when buyer of business expressly assumes seller's liability for an otherwise-incurred item, if amount is included in seller's amount realized)
Reg. § 1.461-4(g)(1)(ii)(C) (express assumption of liability by buyer of business treated as "payment" by seller of an otherwise-incurred item, if amount is included in seller's amount realized)
Reg. § 1.461-4(j) (reserved for treatment of contingent liabilities)
Reg. § 1.1001-2(a)(1) (general rule that amount realized on sale of property includes amount of liabilities from which seller is discharged)
Reg. § 1.1001-2(a)(3) (no amount realized for liability assumption, if liability not included in basis)
Reg. § 1.1274-5(a) (no imputed interest on assumed liabilities in asset sale)
Reg. § 1.1502-76(b)(4) *Example (5)* (if Target leaves consolidated group, deduction for contribution to qualified retirement plan for year may be either claimed for year in which payment is made or allocated ratably between the two short years)
T.D. 9376, 73 Fed. Reg. 2416, 2417 (Jan. 16, 2008) (preamble dealing with section 332 liquidations suggests that, in a sale of a business, if the purchaser assumes an obligation to provide goods or services that as to which the seller deferred income, any amount paid to the purchaser would be taxable income)

Proposed Regulations and Advance Notice of Proposed Rulemaking

Prop. Reg. § 1.263(a)-2(d)(3)(ii)(D) (employee compensation and overhead to acquire tangible property not required to be capitalized)

Prop. Reg. § 1.168-2(d)(3)(i) (when basis of depreciable property redetermined by later events, depreciation on redetermined basis deducted over remaining property life)

REG-125638-01, 67 Fed. Reg. 3461 (Jan. 24, 2002) (advance notice of proposed rulemaking on capitalization treatment of costs incurred in acquiring, creating, or enhancing intangible assets and benefits)

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

Reg. § 1.338(b)-1(c)(1) (fixed liabilities included in buyer's asset basis)

Reg. § 1.338(b)-1(f)(2) (contingent liabilities not included in AGUB, under sections 338(g) and 338(h)(10) (buyer side))

Reg. § 1.338-1T(a)(2) (deemed asset sale taxed as assumption reinsurance transaction)

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

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

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

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

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

Reg. § 1.338(b)-3T(j) Example (1)(iv)-(vi) (contingent liabilities under section 338(g), buyer side (AGUB))

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

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

Court Decisions

Crane v. Commissioner, 331 U.S. 1 (1937) (amount realized on sale of property includes mortgage to which property is subject; *see* especially footnote 6, stating that Commissioner had limited the amount realized to unpaid principal, because unpaid interest "was a deductible item.")

Coolidge v. Commissioner, 40 B.T.A. 1325 (1939), *acq.* 1940-1 C.B. 2 (cash basis Seller's amount realized on sale of real property *held* to include Acquiror's payment of accrued mortgage interest and taxes; Seller entitled to deduct interest and taxes when paid)

Magruder v. Supplee, 316 U.S. 394 (1942) (assumed liability for real estate tax on purchased property added to basis; law changed by I.R.C. § 164(d))

Flood v. United States, 133 F.2d 173 (1st Cir. 1943) (payments by partners to former partnership employees deductible, even though partnership business had been sold)

Oxford Paper Co. v. United States, 86 F. Supp. 366 (S.D.N.Y. 1949), (lessee transferred land and a building to Acquiror, which assumed lessee's obligation on water rights lease; Acquiror reported FMV of land and building as income when received, taxpayer's depreciable cost basis in building *held* limited to allocable portion of contingent liability)

assumed, which was not shown; summary judgment denied to both taxpayer and Government)

Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (after liquidation, a judgment was rendered against liquidated corporation, and the shareholders had to pay the judgment; *held*, because shareholders recognized capital gain on liquidation, payments of the judgment were treated as capital loss when made)

Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d Cir. 1952), *rev'g* 15 T.C. 361, *nonacq.* 1951-1 C.B. 4 (same transaction as in 86 F. Supp. 366; even though taxpayer reported FMV of building as income when received, taxpayer's depreciable cost basis in building *held* limited to allocable portion of contingent liability assumed, zero because of favorable lease terms)

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

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

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

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

Rees Blow Pipe Manufacturing Co. v. Commissioner, 41 T.C. 598 (1964), *aff'd per curiam* 342 F.2d 990 (9th Cir. 1965), *nonacq.* 1966-2 C.B. 8 (after taxpayer participated in tax-free exchange of real property and sold property it received, taxpayer paid damages for concealing defects in property it transferred in exchange and related legal fees; citing *Arrowsmith*, payments *held* capital loss; court states that, if made before property was sold, payments might have been added to basis)

Columbus and Greenville Ry. v. Commissioner, 42 T.C. 834, 849 (1964) *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966) (acquired property subject to mortgage; amount subject to negotiation with another party also liable; mortgage not added to basis before payment)

F. & D. Rentals, Inc. v. Commissioner, 365 F.2d 34 (7th Cir. 1966), *aff'g* 44 T.C. 335 (1965), *cert. denied* 385 U.S. 1004 (1967) (unfunded pension liability assumed by buyer of business but not timely paid; liability *held* not deductible or added to asset basis when assumed because contingent; *dictum* that payment would be deductible under section 404(a)(1) when made)

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

United States v. Shelby Oil Co., 394 U.S. 678 (1969) (taxpayer realized income from natural gas production and claimed percentage depletion deduction; later taxpayer refunded a portion of the income; *held*, deduction for refund was reduced by percentage depletion)

Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 904 (1971) (short-swing insider trading profit payment under section 16(b) of Securities Exchange Act of 1934 deductible as capital loss, not ordinary deduction, because profit was taxed as capital gain; same result in *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973), *Cummings v. Commissioner*, 506 F.2d 449 (2d Cir. 1974), and *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976))

Lemery v. Commissioner, 52 T.C. 367 (1969), *aff'd per curiam*, 451 F.2d 173 (9th Cir. 1971) (covenant not to compete from seller of motel not amortizable, *inter alia*, because obligation to pay for covenant was contingent on net profits of motel)

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

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

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

Of Course Inc. v. Commissioner, 499 F.2d 754 (1974) (corporation's legal fees directly related to sale of capital assets under section 337 liquidation must be capitalized)

Denver & Rio Grande Western R.R. v. United States, 505 F.2d 1266, (Ct. Cl. 1974) (mining company paid cost of rail line to its mine; railroad owned the line and was to repay cost out of future revenue; railroad's basis in line includes only amounts actually paid; contingent obligations excluded from basis; *see also Denver & Rio Grande Western R.R. v. Commissioner*, 32 T.C. 43 (1959), *aff'd on other issues* 279 F.2d 368 (10th Cir. 1960))

Bresler v. Commissioner, 65 T.C. 182 (1975) (antitrust settlement received by shareholder of S corporation constituted ordinary income to the extent it compensated for ordinary losses reported upon sale of corporate assets in prior year)

Smith v. Commissioner, 67 T.C. 570 (1976) (capital loss treatment imposed on seller of unregistered stock for payments he made in class action settlement of alleged Securities Act violations arising from the sale)

Benedict Oil Co. v. United States, 582 F.2d 544 (10th Cir. 1978) (business expense deduction denied to corporation for legal and accounting expenses incurred in sale of assets during plan of complete liquidation under section 337)

Hyde v. Commissioner, 69 T.C. 300 (1978) (taxpayer acquired property by quitclaim, subject to mortgages in foreclosure proceedings, then redeemed property; taxes and interest accruing after quitclaim *held* deductible, pre-quitclaim taxes and interest capitalized; redemption fee deductible as interest)

Abdalla v. Commissioner, 69 T.C. 697 (1978) (taxpayer denied reduction of gain recognized on liquidation of the corporations for Federal income tax deficiencies owed by corporations and assumed by taxpayer as transferee; losses to be recognized later, when tax payments made)

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

Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981), *acq.*, 1986-2 C.B. 1 (cash basis Seller of assets treated as paying payables assumed by Acquiror, because Acquiror assumed liabilities instead of paying more cash; Acquiror increases basis in assets by same amount)

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

Boothe v. Commissioner, 82 T.C. 804 (1984), *rev’d on other grounds*, 768 F.2d 1140 (9th Cir. 1985) (payments made by Seller on breach of warranty claim by Acquiror related back to sale of real property rights under *Arrowsmith*; Seller entitled to capital loss)

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

United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) (casino company’s liability to pay jackpot on progressive slot machines fixed by state regulation requiring payment, even before a player wins – deductible under “all events” test under section 162(a); *but see* I.R.C. § 461(h), enacted later)

Waddell v. Commissioner, 86 T.C. 848, 898-912 (1986), *aff’d per curiam*, 841 F.2d 264, (9th Cir. 1988) (property basis does not include contingent note)

United States v. General Dynamics Corp., 481 U.S. 239 (1987) (employee medical claims not deductible under “all events” test before claims filed)

Transamerica Corp. v. United States, 999 F.2d 1362 (9th Cir. 1993), *rev’g* 670 F. Supp. 1454 (N.D. Cal. 1986) (under income forecast method, cost basis of film includes estimated “participations” and “residuals” payable to actors, writers, producers, etc. – *but see* I.R.C. § 167(g)(1)(B), enacted later (basis includes only costs that satisfy economic performance test))

Mitchell v. Commissioner, T.C. Memo 1994-237 (taxpayer who indirectly purchases stock from savings and loan in violation of Federal Home Loan Bank Board’s regulations, couldn’t currently deduct the amount he paid to savings and loan to compensate it for lost tax benefits resulting from the transaction; payment was made to protect capital asset and so is included in stock basis)

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

Exxon Mobil Corp. v. Commissioner, 114 T.C. 20 (2000) (dismantlement, removal, and restoration costs relating to oil wells and to production equipment and facilities not sufficiently definite and fixed to be accruable under the all-events test of §1.461-1(a)(2))

Chrysler Corporation v. Commissioner, T.C. Memo 2000-283 (costs of satisfying automobile warranties not sufficiently definite and fixed to be accruable under all-events test of §1.461-1(a)(2) at time of sale of automobiles dealers)

United Dairy Farmers, Inc. v. Commissioner, 267 F.3d 510 (6th Cir. 2001) (corporation's environmental clean-up costs for contaminated properties were capital, not currently deductible expenses since contamination already existed at time of purchase)

Illinois Tool Works, Inc. v. Commissioner, 117 T.C. 4 (2001), *aff'd* 355 F.3d 997 (7th Cir. 2004) (Acquiror of Target's assets assumed liability for and paid Target's patent infringement liability; even though unexpected, payments *held* not deductible, but added to Target's asset basis when made; *Webb* followed)

Putnam-Greene Financial Corp. v. United States, 308 F.Supp. 2d 1374 (M.D. Ga. 2004) (litigation expenses incurred by corporation in defending against suits by minority shareholders of corporation it acquired were deductible as a matter of law, but treatment of other shareholder litigation costs submitted to jury)

United States v. Maginnis, 93 AFTR 2d 2004-660 (9th Cir. 2004) (lump sum received for assignment of state lottery installment payments *held* ordinary income; right to receive lottery payments not a capital asset under "substitute for ordinary income" doctrine)

Revenue Rulings and Notice

Rev. Rul. 55-675, 1955-2 C.B. 567 (no gain to Acquiror on acquisition of property and assumption of liabilities; Acquiror's basis excludes "contingent and indefinite" liabilities "until they become fixed and absolute and capable of determination with reasonable accuracy"; *Oxford Paper* distinguished)

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

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

Rev. Rul. 75-154, 1975-1 C.B. 186 (pension payments by former partners of terminated partnership deductible; *Flood* followed)

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

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

Rev. Rul. 80-235, 1980-2 C.B. 229 (nonrecourse note not included in asset basis because speculative)

Rev. Rul. 81-262, 1981-2 C.B. 164 (nonrecourse note transferred in satisfaction of franchise fee is a contingent obligation; even if noncontingent, no deduction because nonrecourse note is not cash or property under 153(d)(2)(b))

Notice 2001-44, 2001-2 C.B. 77 (solicits comments on methods of accounting for contingent nonperiodic payments made pursuant to notional principal contracts under Reg. § 1.446-3)

Chief Counsel Guidance

GCM 34418 (Feb. 3, 1971) (Background to Rev. Rul. 71-450; Chief Counsel reaffirms *Pierce* and Rev. Rul. 68-112 in response to Department of Justice concerns)

PLR 7816063 (Jan. 23, 1978) (after purchase of Target stock and liquidation of Target under old section 334(b)(2), acquiring parent may deduct contributions to Target's qualified pension plan, including those attributable to unfunded plan liabilities)

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

PLR 8152056 (Sept. 29, 1981) (after purchase of Target stock, Acquiror established qualified pension plan to continue benefits under Target plan; Acquiror may deduct contributions to Target's qualified pension plan, including those attributable to unfunded plan liabilities)

PLR 8202115 (Oct. 16, 1981) (similar to PLR 8152055)

PLR 8205022 (Nov. 3, 1981) (after purchase of Target's assets, Acquiror adopted a new qualified pension plan to pay benefits under a frozen qualified pension plan, including Target's unfunded liability; Acquiror may deduct contributions to the new plan, including those attributable to unfunded plan liabilities)

PLR 8411106 (Dec. 16, 1983) (similar to GCM 39274)

TAM 8436002 (Mar. 23, 1984) (similar to GCM 39274)

PLR 8429014 (Apr. 16, 1984) (payments by Seller of Target stock to Target's medical claims administrator after stock sale ruled capital contributions, not income to Target, and deductible to Target; payments by purchaser of Target stock to Seller for tax benefit of medical payments ruled adjustments to purchase price for Target stock)

GCM 39274 (Aug. 16, 1984) (payments to meet pre-acquisition minimum funding requirements to continue qualified pension plan deductible to Acquiror as made, even if computed in part by reference to past service -- *Webb* distinguished; but payment of liability to PBGC for termination of plan and liability for unpaid benefits capitalized)

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

PLR 8749076 (Sept. 11, 1987) (similar to PLR 8612050)

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

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

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

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

PLR 9313025 (Jan. 5, 1993) (taxpayer's basis in alternative energy plant is cost less agency funds provided via contingent loan; basis will be restored as payments are made to agency)

PLR 9317005 (Jan. 15, 1993) (similar to PLR 9313025)

FSA 1999-1068 (Oct. 8, 1993) (Acquiror's assumption and payment of retiree health and life insurance benefit capitalized; if no legal obligation to close the plant, plant closure expenses deductible)

TAM 9438001 (Apr. 21, 1994) (Target may deduct amounts paid by Acquiror to acquire Target's employee stock options, SARs, etc.; Acquiror's treatment not discussed)

FSA 1994 FSA LEXIS 490 (May 9, 1994) (similar to GCM 39274)

TAM 9540003 (June 30, 1995) (in connection with successful tender offer by Acquiror for Target stock, Target made payments to cancel its stock options and stock appreciation rights; amounts paid reflected "premium" in Target stock value from Acquiror's offer; Target may deduct all amounts paid, including "premium")

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

TAM 9731001 (Jan. 31, 1997) (similar to TAM 9721002)

TAM 9832002 (Feb. 5, 1998) (prepaid subscription to partnership, deferred under section 455, treated as "liability" that increases basis in partnership interests)

PLR 9842008 (Oct. 16, 1998) (payments by Seller of Target stock for later-discovered environmental contamination liabilities of Target related back to the sale; Seller entitled to capital loss)

PLR 200004040 (Oct. 29, 1999) (on sale of nuclear power plant, Seller transferred plant assets, including decommissioning fund assets, and Acquiror assumed decommissioning liability; Seller includes in amount realized at closing present value of liability assumption, but simultaneous offsetting deduction allowed; Acquiror recognizes no gain on receipt of decommissioning funds (Rev. Rul. 71-450 distinguished); Acquiror may not allocate decommissioning liability specially as consideration paid for fund assets but must use section 1060 and allocate all consideration to all assets)²

TAM 200048006 (Aug. 14, 2000) (same as FSA 200048009) (on sale of stock with a 338(h)(10) election, Seller indemnified Acquiror and "New T" for pre-acquisition taxes;

² This PLR is substantially similar to several others. *See, e.g.*, PLR 200302013 (Sept. 30, 2002); PLRs 200302009-12 (Sept. 27, 2002); PLR 200218019 (Jan. 30, 2002); PLR 200215037 (Jan. 14, 2002); PLR 200126011 (Mar. 26, 2001); PLR 200125066 (Mar. 26, 2001); PLR 200125007 (Feb. 20, 2001); PLR 200121028 (Feb. 20, 2001); PLR 200042006 (July 11, 2000); PLR 200037020 (June 9, 2000); PLRs 200034007-08 PLR 200034009 (May 18, 2000); PLR 199943041 (July 21, 1999); PLR 199952074 (Sept. 28, 1999). *See* Reg. § 1.338-6(c)(5) (2007).

Acquiror may only deduct post-acquisition interest on state tax liability; New T makes upward adjustment to basis of its assets when state tax liability and pre-acquisition interest become fixed and determinable and downward adjustment to basis when payments are made by Seller to the state tax authority)

FSA 200047015 (Aug. 16, 2000) (parent may not deduct cost of reimbursing its first subsidiary the cost of paying a legal judgment against parent's second, arguably bankrupt subsidiary, when cause of action arose against second subsidiary before parent purchased subsidiary, and despite oral agreement (confirmed by letter) between parent and first subsidiary that parent would pay judgment)

FSA 200110020 (Dec. 6, 2000) (Acquiror cashed out nonqualified stock options after acquiring stock of Target and causing target to be merged into Acquiror; payments deductible by Target, not Acquiror; issue whether merger caused Acquiror to step into Target's shoes and so become eligible for deduction referred to Associate Chief Counsel (Corporate))

PLR 200127022 (Apr. 4, 2001) (damages paid by physician who sold his practice and then violated terms of covenant not to compete deductible under section 162(a))

FSA 200148006 (July 30, 2001) (funding of employee bonus plan of target corporation by acquiring corporation as a condition to a section 338(h)(10) transaction is capital expenditure; distributions from plan for post-acquisition services may be currently deducted as compensation expense)

TAM 200427023 (March 5, 2004) (target whose stock was sold received indemnity payment from assignee of seller of target stock for breach of contractual obligations assumed by assignee; payment taxed as ordinary income; *Arrowsmith* not applied)

PLR 200510008 (Nov. 23, 2004) (Rural electric cooperative purchased electricity with price subject to adjustment 75 days after year-end; *ruled*, adjustment meets all parts of the "all events" test under sections 451 and 461, including requirement that amount be "determinable"; thus, income for year of power delivery takes adjustment into account)

PLR 200602028 (Sept. 28, 2005) (sale of nuclear power plant to City, which assumes decommissioning liability through nonqualified nuclear decommissioning Trust; Seller continues to collect rates from customers and remitting funds to Trust as City's agent; Seller allowed deduction at closing to offset amount realized attributable to City's assumption of decommissioning liability; Seller's collections as agent not taxable to Seller)

PLR 200730014 (July 27, 2007) (purchaser of gas marketing business paid customers to terminate pre-existing contracts to supply gas at fixed price and substitute contracts at fluctuating prices; payment deductible to buyer, not capitalized as adjustments to purchase price, because obligation contingent on gas purchases and market price, and because contracts not taken into account in determining purchase price)

Commentary

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- K. Keyes, "The Treatment of Contingent Liabilities in Taxable Acquisitions," 4 PLI, The Corporate Tax Practice Series, Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2009, 515
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- J. Cummings, "Capitalization—Selling Nuclear Decommissioning Funds," 195 DTR J-1 (Oct. 12, 2010)

TAXABLE STOCK ACQUISITIONS – CONTINGENT LIABILITIES AND INDEMNITIES

Code Provisions

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

Regulations

- Reg. § 1.1502-11(b) (on sale of stock of consolidated return subsidiary Target, Target's loss in year of sale does not offset gain from sale of Target stock; limitation intended to prevent a cycle of reductions in the basis of the Target stock that absorbs the Target loss with no tax benefit)
- Reg. § 1.1502-76(b) (on sale of stock of consolidated return subsidiary Target, rules to determine whether selling consolidated group takes into account Target deductions generated in year of sale, or whether Target takes these deductions into account during its next taxable year)
- Reg. § 1.1502-36(d)(4)(ii)(C) (if stock of consolidated subsidiary (T) is sold at a loss, T's favorable tax attributes (NOLs, asset basis, etc.) may be reduced to prevent loss duplication; if contingent liabilities become payable by T after closing, T may lose deduction if loss on stock sale exceeds attributed available for reduction)

Court Decisions

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

Deputy v. Dupont, 308 U.S. 488 (1940) (expense incurred by shareholder to borrow corporation stock to be provided to members of corporation's executive committee not deductible, because incurred for benefit of corporation)

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

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

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

Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964) (expenditures by parent corporation to corporate subsidiary's employees not deductible by parent)

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

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

Clay v. Commissioner, T.C. Memo 1981-375 (1981) (Sellers of stock of vending machine company indemnified Acquiror against undisclosed liabilities; indemnity payment *held* offset against sale proceeds and capital loss to Seller under *Arrowsmith*, not ordinary deduction; litigation expenses for arbitration to determine indemnity damages also capital expenditures)

Inland Asphalt Co. v. Commissioner, 756 F.2d 1425 (9th Cir. 1985) (indemnity payment by Target (an S corporation) to Seller of Target stock for tax deficiencies on previous transaction treated as dividend, not sale price adjustment, because payments related back to the prior transaction, not the sale of Target stock)

Revenue Ruling and Notice

Rev. Rul. 58-374, 1958-2 C.B. 396, *clarified by* Rev. Rul. 83-73, 1983-1 C.B. 84 (by agreement, Seller of Target stock indemnified Target for pre-sale Federal income tax and all interest thereon through payment, and Target paid over to Seller Federal excess profits tax refunds it received, including interest thereon (less income tax paid on the interest by Target); tax payment and refund and interest paid and received thereon are all adjustments to the purchase price of the Target stock under *Arrowsmith*)

Notice 2003-65, 2003-2 C.B. 747 (IRS requests comments on how built-in loss items should be treated under section 382(h))

Rev. Rul. 2003-98, 2003-2 C.B. 378 (Target grants nonqualified stock options to employee; later, Acquiror buys Target stock and grants Acquiror stock options to employee, who surrenders his Target options; employee recognizes compensation income when Acquiror option is exercised or cashed-out; Target, not Acquiror, gets offsetting deduction)

Chief Counsel Guidance

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

PLR 8429014 (Apr. 16, 1984) (Seller of Target stock made payments to Target's medical claims administrator after stock sale; payments ruled capital contributions, not income to Target, and deductible to Target; payments by Acquiror of Target stock to Seller for tax benefit of medical payments ruled adjustments to purchase price for Target stock; *see* CCA 200901033 (Sept. 5, 2008), below)

PLR 9029058 (Apr. 25, 1990) (assumption by Seller of Target stock of Target's above-market lease obligation ruled contribution to capital, not income to Target)

FSA 199942025 (July 27, 1999) (corporation entitled to current deduction for environmental cleanup costs even though costs are subject to indemnification under stock purchase agreement; VCA followed)

FSA 200147013 (July 10, 2001) (on sale of Target stock, Seller assumed liability for claims against Target; Seller's subsidiary incurred expenses to administer these claims; expenses not deductible to Seller's subsidiary because they are Target's expenses, and under *Arrowsmith*, they relate back to the sale of Target stock; thus, capital loss to Seller; VCA followed)

LAF 20055202F (Sept. 13, 2005) (In sale of stock, Target purports to distribute to Seller the right to specified percentage of anti-dumping subsidy payments received by Target after closing; Purchaser remits such amounts to Seller; dividend declaration treated as executory promise to pay dividend in the future and disregarded, because contingent on anti-dumping award; subsidy payments taxable to Target as received and additional; payment to Seller treated as additional purchase price)

PLR 200518014 (Dec. 30, 2004) (consolidated parent C sells stock of X and Y to consolidated parent B; parties agreed that any X or Y NOL in post-closing years would not be carried back to pre-closing years; after law was changed to increase carryback period from 2 years to 5 years, under new agreement C claimed refund for carryback of X and Y NOLs to pre-closing years and paid 2/3 of refund to B; *ruled*, payment by C to B not adjustment to purchase price for X and Y stock under *Arrowsmith*, because made under new agreement; payment deductible to C and ordinary income to B; *see* J. Prusiecki, "Brilliant Advocacy or Very Good Luck?" 107 Tax Notes 1751 (June 27, 2005))

CCA 200901033 (Sept. 5, 2008) (supplemental to PLR 8429014 (Apr. 16, 1984), above; Target and Acquiror merged into X Corp.; payments by Seller to claims administrator after merger ruled capital contributions by Seller to X, with same effect as pre-merger payments; tax benefit payments by X to Seller ruled to have no tax effect to X, because the Target stock basis had disappeared in the merger, but still to offset Seller's capital losses from the payments to claims administrator)

TAX-FREE TRANSACTIONS

TAX-FREE TRANSACTIONS – CONTINGENT AND ESCROWED STOCK AND OPTIONS TO ACQUIRE STOCK

Code Provisions

- Section 163(l) (no deduction for interest on debt instruments payable in issuer stock)
- Section 356(a)(1) (gain, but not loss, is recognized to the extent of the lesser of the fair market value of the warrants or the cash received)
- Section 483(f) (regulation authority on imputed interest for contingent payments)

Regulations and Treasury Decisions

- Reg. § 1.354-1(d) Example 4 (Section 354 does not apply to an exchange of common stock for options to acquire stock of the same company)
- Reg. § 1.356-1(a) (gain, but not loss, is recognized to the extent of the lesser of the fair market value of the warrants or the cash received)
- Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b) (options to acquire stock treated as “zero-principal” securities)
- Reg. § 1.356-3(c) Examples 7, 8, and 9 (illustrating the effect of a right to acquire stock having no principal amount).
- Reg. § 1.356-6 (nonqualified preferred stock exchanged for anything other than NQPS or a right to acquire NQPS is not stock or securities under Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b))
- Reg. §§ 1.368-1T(e)(2) (TD 9316, March 20, 2007) (contingent or escrowed consideration received by target shareholders in purported reorganization does not prevent value of stock from being fixed, for continuity-of-interest purposes, at the time a binding contract is entered into, if described conditions are met)
- Reg. §§ 1.368-1T(e)(2)(v) Example 2 (TD 9316, March 20, 2007) (escrowed stock forfeited to Acquiror after purported reorganization; value of stock still may be fixed, for continuity-of-interest purposes, at the time a binding contract is entered into, but forfeited stock does not count toward continuity)
- Reg. § 1.483-4(b) Example (2) (imputed interest but no OID on contingent stock issued in reorganization; right to receive contingent stock not a “debt instrument”)
- 61 Fed. Reg. 67508 (Dec. 23, 1996) (treatment of options to acquire stock as zero-principal-amount securities)
- T.D. 8752 (Jan. 6, 1998) (adopting final Regulations regarding treatment of options to acquire stock as zero-principal-amount securities)
- T.D. 8882 (May 16, 2000) (adopting final Regulations regarding treatment of exchange of NQPS for purposes of sections 354, 355, and 356)

Court Decisions

- Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942) (stock options are not stock)
- Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960) (right to receive contingent stock treated as “stock” eligible for tax-free treatment in reorganization)
- Hamrick v. Commissioner*, 43 T.C. 21 (1964), *acq. in result only*, 1966-2 C.B. 5 (right to receive contingent stock treated as “stock” eligible for tax-free treatment in reorganization)

Fox v. United States, 510 F.2d 1330 (1974) (imputed interest required in contingent stock deal)
Solomon v. Commissioner, 67 T.C. 379 (1976) (*see Fox*)
Jeffers v. United States, 556 F.2d 986 (Ct. Cl. 1977) (*see Fox*)
Catterall v. Commissioner, 68 T.C. 413 (1977) (*see Fox*)
Cocker v. Commissioner, 68 T.C. 544 (1977) (*see Fox*)
Katkin v. Commissioner, 570 F.2d 139 (6th Cir. 1978) (*see Fox*)
Vorbleski v. Commissioner, 589 F.2d 123 (3d Cir. 1978) (*see Fox*)
Feifer v. United States, 500 F.Supp. 102 (N.D. Ga. 1980) (*see Fox*)
Kingsley v. Commissioner, 662 F.2d 539 (9th Cir. 1981) (*see Fox*)
Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1987) (*see Fox*)

Revenue Rulings and Revenue Procedure

Rev. Rul. 57-586, C.B. 1957-2, 249 (certificates of contingent interests in stock of Acquiror received by Target shareholders in merger of Target into Acquiror treated as boot, not stock, because transferable; *Carlberg* not followed)
 Rev. Rul. 66-112, 1966-1 C.B. 68 (contingent right to receive additional Acquiror voting stock based on Target's future earnings not treated as boot and not inconsistent with B reorganization, because non-assignable; *Hamrick* followed; interest on delayed receipt of stock subject to interest imputation under section 483)
 Rev. Rul. 67-90, 1967-1 C.B. 79 (same as Rev. Rul. 66-112, where number of additional shares contingent on future FMV of Acquiror stock)
 Rev. Rul. 70-120, 1970-1 C.B. 124 (no imputed interest on escrowed stock in reorganization, if Target shareholders vote and receive dividends)
 Rev. Rul. 70-300, 1970-1 C.B. 125, *clarified*, Rev. Rul. 72-35, 1972-1 C.B. 139 (imputed interest on contingent stock issued in reorganization)
 Rev. Rul. 72-32, 1972-1 C.B. 48 (interest accrues on contingent stock based on earn-out in reorganization; interest deductible when obligation to issue contingent stock becomes fixed)
 Rev. Rul. 73-298, 1973-2 C.B. 173 (in reorganization like that of Rev. Rul. 67-90, where Target shareholders receive contingent stock; section 483 interest imputation applies)
 Rev. Rul. 75-456, 1975-2 CB 128 (contingent stock issued in reorganization remains tax-free when exchanged for stock of second acquiror in second reorganization – *see also* PLR 9838007 (June 16, 1998))
 Rev. Rul. 76-42, 1976-1 C.B. 102 (return of escrowed stock issued in B reorganization, based on FMV of stock at time of reorganization, treated as adjustment of acquisition price; no gain or loss to shareholder)
 Rev. Rul. 76-334, 1976-2 C.B. 108 (escrowed stock in C reorganization returned in settlement of dispute for cash equal to half of stock value; cash payment viewed as separate redemption of stock in value equal to cash; “solely for voting stock” test not violated; remaining stock returned, based on FMV of stock at time of reorganization; treated as adjustment to acquisition price, and no gain or loss to shareholder on stock returned)
 Rev. Rul. 78-376, 1978-2 C.B. 149 (return of escrowed stock issued in C reorganization, based on FMV of stock at time of return, treated as taxable sale of escrowed stock)
 Rev. Proc. 84-42, 1984-1 C.B. 521 (advance ruling guidelines for contingent and escrowed stock in reorganizations)

Rev. Rul. 2007-49, 2007-31 I.R.B. 237 (subjecting vested shares owned by employee to new restrictions, making them nonvested, has no effect under that provision; exchange of vested shares for nonvested shares in tax-free reorganization treated as transfer under section 83, but tax-free and eligible for section 83(b) election; if exchange is a taxable exchange, gain or loss is recognized on transfer of vested shares, but receipt of nonvested stock is still eligible for section 83(b) election)

Chief Counsel Guidance

PLR 9827027 (Apr. 3, 1998) (example of private ruling on contingent and escrowed stock)
PLR 200052027 (Sept. 29, 2000) (§ 163(l) does not disallow deductions for interest paid or accrued on notes issued at the same time issuer purchases put options on its convertible preferred stock)

Commentary

D. Tillinghast, "Contingent Stock Pay-Outs in Tax-Free Reorganizations," 22 Tax Lawyer 467 (1969)
J. P. Holden, "Unraveling the Mysteries of Section 305," 36th Ann. N.Y.U. Inst. Fed. Tax'n 781 (1978)
R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981)
J. Fleming, "Rethinking Contingent Price Reorganizations," 9 J. Corp. Tax'n 3 (1982)
FAS No. 128 (1997) (treatment of escrowed and contingent stock in computing earnings per share for financial accounting purposes)
M. Jackel & J. Blanchard, "Reflections on Liabilities: Extension of New Law to Partnership Formations," 91 Tax Notes 1579 (2001)
R. Willens, "Contingent Stock Acquisitions Should Gain Popularity in Uncertain Times," Daily Tax Report June 23, 2003
J. L. Cummings & R. P. Hanson, "New Limitations on Corporate Built-in Losses," 107 Tax Notes 1553 (2005)
K. Keyes, "Dealing With Contingent Stock and Contingent Liabilities in Tax-Free Transactions," 11 PLI, The Corporate Tax Practice Series, Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2009, 555
American Bar Ass'n Section of Taxation, "Comments on Temporary and Proposed Regulations Regarding the Measurement of continuity of Interest Under Section 368" (Feb. 26, 2010)

TAX-FREE TRANSACTIONS – CONTINGENT LIABILITIES

Code Provisions

Section 357(c)(3) (liability excluded from section 357(c) computation if payment would give rise to a deduction)
Section 357(d) (separate rules for recourse and nonrecourse liabilities to determine whether a liability is treated as "assumed" so as to result in basis step-up and possible gain recognition in otherwise tax-free asset transfer (enacted by Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(1) (106th Cong., 1st Sess. 1999))

Section 358(d) (where shareholder transfers property to corporation (section 351 or 361), and corporation assumes liability giving rise to deduction (section 358(d), stock basis reduced by this liability to extent stock basis exceeds FMV – exception for full business transfers, as in Rev. Rul. 95-74; note: Treasury directed to adopt similar rule for partnership transfers (Pub. L. No. 106-554, § 309(c)))

Section 358(h) (loss disallowance rule (enacted in the Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, § 309(a) (106th Cong. 2d Sess. 2000)) that reduces the basis of the stock to the extent that (i) it exceeds the stock's fair market value, and (ii) a liability (including a contingent liability) is assumed by the transferee corporation in exchange for the stock)

Section 362(d) (limitation on asset basis step-up attributable to assumed liabilities: no basis increase above FMV; liability assumption disregarded for asset basis purposes if no tax paid on recognized gain)

Section 362(e) (2004 Jobs Act amendment to limit importation of net built-in losses in section 351 exchanges and reorganizations, including contingent liabilities)

Section 381(c)(16) (in acquisitive reorganization, Parent succeeds to deduction of Target's deductible liabilities, except those which reduce consideration paid in reorganization; *see also* I.R.C. § 381(c)(4))

Section 7701(o) (where the economic substance doctrine applies, taxpayer must show both non-tax change in economic position and business purpose)

Legislative Proposals

Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong., 1st Sess. (1999), Section 1512 (would have broadened anti-abuse rule of section 357(b) by changing “the principal purpose” to “a principal purpose” and eliminating “on the exchange” – vetoed September 23, 1999)

Regulations, Treasury Decisions and Proposed Regulations

Reg. § 1.301-1(g) (applying section 357(d) definition of an assumption to distributions under section 301)

Reg. § 1.358-5 (section 358(h), which reduces basis of stock of transferee corporation in section 351 exchange and reorganization for contingent liabilities, to extent of net loss, applied without regard to exception for transfers substantially all of the assets associated with the liability)

Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a), (c) (deductibility of payments of Target obligations by Parent after reorganization)

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

T.D. 8924 (Dec. 20, 2000) (in adopting Temp. Reg. § 1.301-1T(g), Treasury and IRS announce that regulations will be adopted on payments of assumed liabilities; interim view is that payment by non-assuming person treated as, *e.g.*, dividend or capital contribution)

T.D. 9062, 68 Fed. Reg. 37,414 (June 24, 2003), Reg. § 1.752-6T (applying principles of section 358(h) to liabilities assumed by partnerships – effective for transactions from October 18, 1999 until June 24, 2003)

T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005). Reg. §§ 1.358-7, 1.752-0, 1.752-1, 1.752-6 and 1.752-7 (system to account for partnership “obligations” – other than “liabilities” taken

into account in income, gain or asset basis; actual or deemed assumption by partnership of such obligations does not result in immediate reduction of partner's basis in partnership interest; instead, (1) any deduction or capital item resulting from obligation becoming a "liability" (e.g., payment of a deductible item) is allocated among partners using section 704(c) principles, and (2) if obligation is separated from partner to whom allocated (e.g., partner disposes of partnership interest), basis in partnership interest is reduced at that time, and later deduction is available only to that partner)

Notice of Proposed Rulemaking, REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11903 (Mar. 10, 2005) (Transfer cannot qualify as reorganization, section 351 exchange or section 332 liquidation unless net value – fair market value of assets over amount of liabilities – is transferred; "liabilities" include all obligations, whether or not taken into account for other tax purposes, but method of determining amount of liabilities not specified)

Proposed Reg. §§ 1.362-4(e)(3) and (4) (in section 351 transfer of net loss assets, if stock basis reduction is elected instead of asset basis reduction, stock basis is reduced by amount of net built-in-loss in gross assets; contingent liabilities not taken into account for this purpose)

Advance Notice of Proposed Rulemaking

Advance Notice of Proposed Rulemaking, REG 100818.01, RIN 1545-A474, "Liabilities Assumed in Certain Transactions" (also Announcement 2003-37), 68 Fed. Reg. 23,931 (May 6, 2003) (request for comments regarding assumption of numerous liabilities in section 351 exchange)

Court Decisions

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

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

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

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

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

Rodney, Inc. v. Commissioner, 145 F.2d 692 (2d Cir. 1944) (liability for accrued interest assumed by shareholder in liquidation of corporation and later paid by shareholder capitalized and not deductible)

Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946) (after incorporation of partnership, transferee corporation paid contingent tort liabilities incurred

by partnership; payment *held* part of consideration paid for partnership business, not deductible)

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

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

Portland Gasoline Company v. Commissioner, 181 F.2d 538 (5th Cir. 1950) (payment by Buyer of Seller corporation's assets of liability on guarantee by Seller of note issued by Seller's affiliate *held* capitalized in cost of reorganization, not deductible)

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

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

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

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

Central Electric & Gas Co. v. United States, 159 F. Supp. 353 (Ct. Cl. 1958) (In purchase of corporate stock, Seller agreed to indemnify Buyer for pre-closing tax and interest in excess of amount reserved; pre-closing tax and interest assessed against Target but paid by Seller; *held*, interest deductible to Target)

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

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

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

Enoch v. Commissioner, 57 T.C. 781 (1972), *acq. in part*, 1974-2 C.B. 2, 4, *nonacq.*, 1974-2 C.B. 5 (where a liability is treated as assumed by the transferee, a later payment by the

party whose liability was treated as assumed should be treated in accordance with the relationship of the parties).

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

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

Helmer v. Commissioner, T.C. Memo. 1975-160 (option written by partnership not a liability under section 752, because it could expire unexercised)

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

Long v. Commissioner, 71 T.C. 1 (1978), *aff'd in part and rev'd on other grounds*, 660 F.2d 416 (10th Cir. 1981) (contingent liabilities such as those arising out of lawsuits not section 752 liabilities until fixed or liquidated)

Salina Partnership LP, FPL Group, Inc. v. Commissioner, T.C. Memo. 2000-352 (short sale obligation had economic substance and was a section 752 liability; court emphasized need to achieve "parity between a partnership's aggregate inside basis in its assets and its partners' outside bases in their partnership interests" and distinguished *Helmer*, noting that there option could lapse unexercised but in short seller had obligation to close short sale)

Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), *aff'g in part, rev'g and remanding in part* 340 F. Supp. 621 (D. Md. 2004) (contingent liability shelter – loss on sale of stock received in section 351 exchange including assumption of OPEB liabilities – summary judgment for taxpayer reversed)

Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), *rev'g* 94 AFTR 2d 2004-6708 (Ct. Fed. Cl. 2004), *cert. denied* 167 L.Ed.2d 76 (2007) (contingent liability shelter—in section 351 exchange involving assumption of contingent liability, contingent liability treated as "liability" for purposes of sections 357 and 358, and basis of stock of transferee corporation not reduced, because liability would result in deduction; loss on sale of stock of transferee corporation disallowed for lack of economic substance in transaction in which liabilities were assumed)

Klamath Strategic Investment Fund, L.L.C. v. United States, 98 AFTR 2d 2006-5495 (E.D. Tex. 2006), 472 F. Supp. 885 (E.D. Tex. 2007), *reconsideration denied*, 99 AFTR 2d 2007-2001 (2007), *aff'd*, 103 AFTR 2d 2009-2220 (5th Cir. 2009) (in offsetting option "Son-of-BOSS" borrowing and partnership investment transaction, purportedly as part of foreign currency investment strategy, district court held that Reg. § 1.752-6 could not be applied retroactively against taxpayer, because taxpayer was justified in relying on prior law, but disallowed claimed tax benefits, because the transactions lacked economic substance)

(although allowing deductions for related interest and expenses); court of appeals affirmed on the economic substance ground, declined to take up retroactivity issue and reversed district court decision to allow interest and expense deductions)

Jade Trading LLC, et al. v. United States, 80 Fed. Cl. 11, 100 AFTR 2d 2007-7123 (Ct. Fed. Cl. 2007) *aff'd* 598 F.3d 1372 (Fed. Cir. 2012) (offsetting foreign currency transactions lacked economic substance; *Coltec* applied to reach conclusion that obligation did not constitute section 752 liability)

Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008) (tax benefits of offsetting option Son-of-BOSS transaction disallowed; Reg. § 1.752-6 applied retroactively against taxpayer)

Kornman & Associates, Inc. v. United States, 101 AFTR 2d 2008-785 (5th Cir. 2008), *aff'g Colm Producer, Inc. v. United States*, 460 F. Supp.713 (N.D. Tex. 2006) (tax benefits of short sale Son-of BOSS transaction disallowed, because short sale obligation treated as a section 752 liability under revenue rulings in effect before Reg. § 1.752-6)

Sala v. United States, 101 AFTR 2d 2008-1843 (D. Colo. Apr. 22, 2008) (tax benefits of offsetting option Son-of BOSS transaction allowed as having economic substance; *Klamath* distinguished; Reg. § 1.752-6 could not be applied retroactively against taxpayer; *Cemco* rejected)

Stobie Creek Investments LLC v. United States, 82 Fed. Cl. 636, 102 AFTR 2d 2008-5442 (Ct. Fed. Cl. 2008), *aff'd* 105 AFTR 2d 2010-___ (Fed. Cir. 2010) (obligation from offsetting foreign currency transaction did not constitute a section 752 liability because it lacked economic substance; and court used step transaction doctrine to collapse steps, retroactive application of Treas. Reg. § 1.752-6T invalid (this issue not applied))

Marriott Int'l Resorts v. United States, 83 Fed. Cl. 291, 102 AFTR 2d 2008-6039 (Ct. Fed. Cl. 2008) (short sale, predated Notice 2000-44, effective date of Treas. Reg. § 1.752-6T, and Rev. Rul. 95-26, which held that short sales were section 752 liabilities; but, emphasizing need for symmetry in treatment of basis, court relied on Rev. Rul. 88-77 and *Salina*, to hold that short sale obligation constituted section 752 liability)

7050 Ltd. v. Commissioner, T.C. Memo 2008-112 (tax benefits of offsetting option Son-of BOSS transaction disallowed for two reasons: currency options were transferred to partnership after they had expired, and distribution of options by partnership to partner did not fully liquidate partner's interest)

Maguire Partners-Master Invs., LLC v. United States, 104 AFTR 2d 2009-7839 (C.D. Cal. 2009) (offsetting foreign currency options lacked economic substance, were economic shams and were recast under step transaction and substance-over-form doctrines; court also held that option obligation was a section 752 liability, relying on Rev. Rul. 88-77 and noting that short and long option positions were contractually linked; court also applied *Cemco* holding that Treas. Reg. § 1.752-6T was validly applied retroactively)

New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. No. 9 (2009) (offsetting foreign currency option transactions lacked economic substance even though there was small chance of big payout; court did not address whether section 752 liability existed or retroactive applicability of Treas. Reg. § 1.752-6T)

Clearmeadow Investments, LLC v. United States, 103 AFTR 2d 2009-2786 (Ct. Fed. Cl. 2009) (offsetting foreign currency options – taxpayer initially accepted the IRS settlement initiative offer but breached the agreement; court focused on Treas. Reg. § 1.752-6;

taxpayer claimed it transferred a trade or business, an exception to 1.752-6, an argument court rejected; and court held that transaction lacked economic substance)

Revenue Rulings, Notices and Revenue Procedure

- Rev. Rul. 73-146, 1973-1 C.B. 61 (Target could deduct amounts paid by it to employees to terminate nonqualified stock options, in connection with B reorganization)
- Rev. Rul. 80-198, 1980-2 C.B. 113 (on incorporation of its business, cash method proprietorship transferred receivables, and cash method corporation assumed payables; corporation reports receivables as income when collected and deducts payables when paid)
- Rev. Rul. 83-73, 1983-1 C.B. 84, *clarifying* Rev. Rul. 58-374, 1958-2 C.B. 396 (after tax-free merger, Target shareholders reimbursed Parent for pre-merger contingent liability; Parent deducts payment of the liability and reports no income for reimbursement; Target shareholders reduce their basis in Parent stock by reimbursement amount)
- Rev. Rul. 83-155, 1983-2 C.B. 38 (cash method partnership made guaranteed payments to retired partner and deducted them; after incorporation of partnership business, cash method corporation may continue to deduct the payments)
- Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent environmental liabilities of transferor assumed in section 351 transfer of business not “liabilities” for section 357(c) purposes; amounts deductible by transferee as incurred; *Holdcroft* not followed)
- Notice 99-59, 1999-2 C.B. 761 (“BOSS” transaction: corporation distributes property to shareholders, who assume liability that corporation is expected pay; result is loss on corporation’s stock; loss created is artificial and disallowed due to lack of economic substance)
- Notice 2000-44, 2000-2 C.B. 255 (“Son of BOSS” transaction: taxpayer transfers property to a partnership with obligations said not to be treated as “liabilities for section 752 purposes – e.g., premium borrowing or written options on securities – to create a built-in loss in the partnership interest that then would be sold)
- Notice 2001-17, 2001-1 C.B. 730 (stating IRS intention to challenge contingent liability tax shelters on various specified grounds)
- Rev. Rul. 2002-1, 2002-1 C.B. 268 (D grants restricted D stock and nonqualified options on D stock to employees; upon spin-off of C by D, the employees’ rights are cancelled, and restricted stock and nonqualified options on both D and C stock are substituted; when restrictions on stock lapse and options are exercised, no gain or loss is recognized to D or C, and D and C each is entitled to deductions with respect to its own stock)
- Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (settlement procedures relating to contingent liability tax shelters)
- Rev. Rul. 2003-56, 2003-23 I.R.B. 1 (netting of liabilities assumed by each party to section 1031 exchange, for purposes of section 752)

Chief Counsel Guidance

- PLR 7841011 (June 28, 1978) (in shareholder derivative suit arising out of merger of one mutual fund management company into another, individual officers paid a judgment, either in cash or stock; payment not an adjustment to merger consideration and deductible as ordinary income; the fact that stock was used to satisfy the judgment)
- AOD 1981-115 (Apr. 27, 1981), *modifying* O.M. 70587 (May 16, 1980) (*VCA Corp. v. United States*)
- GCM 38977 (Apr. 8, 1982) (Rev. Rul. 83-73)

PLR 9715008 (Dec. 4, 1996) (contingent payments in redemption of partnership interest allocated between principal and interest)

TAM 9716001 (June 17, 1996) (after transfer by Target of business to Parent under section 351, Parent paid vacation pay accrued to Target's employees and was reimbursed by Parent; Parent may deduct payments under section 404(a); reimbursement not income to Parent and does not reduce deduction)

FSA 199905008 (Oct. 29, 1998), *reconsidered by* FSA 199929015 (Apr. 20, 1999) (consolidated group members transferred cash and other assets to Newco, which assumed contingent tort liabilities and then sold Newco stock at a loss; Rev. Rul. 95-74 could apply, but National Office recommends arguing that section 351 did not apply to asset transfer because of no business purpose)

PLR 199919025 (May 14, 1999) (in connection with divisive type-D reorganization, payments between distributing and spun-off corporations for environmental and other liabilities not fixed and determinable at time of spin-off treated as occurring immediately before spin-off. *Query*: Is this conclusion consistent with Rev. Rul. 95-74 (which suggests that spun-off corporation would deduct the indemnity payment when made to distributing payment))

TAM 200006014 (Oct. 22, 1999) (loss on sale of subsidiary stock disallowed under Reg. § 1.1502-20 where parent transferred intercompany debt instruments to subsidiary, and subsidiary assumed contingent liabilities for parent's employee benefits; extensive analysis of Reg. § 1.1502-13(g); *compare* FSA 200128014 (Apr. 10, 2001))

FSA 200008012 (Nov. 8, 1999) (insolvency of Target does not prevent merger from qualifying as reorganization under section 368(a)(1)(A) where the shareholders of the insolvent corporation receive a proprietary interest in exchange for the corporation's assets)

FSA 200121013 (Feb. 12, 2001) (in calculating basis in stock of subsidiary, parent must offset cash transferred to subsidiary by present value of nonqualified deferred compensation liabilities assumed by subsidiary; section 357(c)(3)(A) does not apply because parent remained entitled to take the deduction arising from payment of liabilities subsequent to the exchange)

FSA 200133006 (Apr. 11, 2001) (transfer to controlled corporation of note and obligation to pay rent in same amount treated as payment to discharge rent obligation, not section 351 exchange)

CCA 200117039 (Apr. 27, 2001) (obligation to pay rent in lease strip not subject to section 357(c)(3), loss on sale of stock issued in transaction where this obligation assumed disallowed, even if exchange occurred before effective date of section 358(h))

FSA 200134008 (May 15, 2001) (applying Notice 2001-17 to deny deduction for payments made on contingent employee benefit liabilities assumed in § 351 exchange)

FSA 200122022 (June 4, 2001) (a consolidated group member transferred certain notes receivables to its subsidiary in exchange for the assumption of risk management liabilities and voting preferred stock; loss on subsequent sale of preferred stock disallowed under reasoning of Notice 2001-17; alternatively, loss on stock sale disallowed by Reg. § 1.1502-20)

Notice CC-2001-033a (June 26, 2001) (review of issues in contingent liability tax shelters discussed in Notice 2001-17)

PLR 200218019 (May 3, 2002) (nuclear power company is eligible and electing taxpayer under Reg. §§ 1.468A-1(b) and 1.468A-2, respectively, and pursuant to a section 351

restructuring transaction, liability for decommissioning plants is transferred to partnership/division of company)
CCA 201023056 (Sept. 22, 2009) (spun-off corporation in divisive type-D reorganization may direct payment if contingent liability assumed from its parent, under same theory as Rev. Rul. 95-74; section 234, relief not available)

Commentary

See also commentaries cited in TAXABLE ACQUISITIONS – TAXABLE ASSET AND STOCK ACQUISITIONS – CONTINGENT PURCHASE PRICE, above.

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J. L. Cummings, “‘Closed’ and ‘open’ sales: A recommended alternative,” Cummings’ Corporate Tax Insights, Volume 01, No. 02 (Apr. 22, 2003)

NYS Bar Ass’n Tax Section Committee on Corporations “Report on Proposed Legislation to Amend Section 357(d),” 1999 TNT 18-15 (Jan. 22, 1999)

J. Blanchard & K. Hooker, “Fixing Assumption of Liability Rules: The Wrong Way and the Right Way,” 85 Tax Notes 933 (Nov. 15, 1999)

M. Kliegman & J. Martin, “Whose Liability Is It Anyway? The Impact of Recent Amendments to Section 357,” 91 J. Taxation 341 (Dec. 1999)

M. Banks-Golub, “Recent Amendments to Code Sec. 357: Congress Responds to ‘Artificial Basis Creation,’” 78 TAXES 19 (May 2000)

J. Bogdanski, “Section 357(d) – Old Can, New Worms,” 27 J. Corporate Taxation 17 (Spring 2000)

J. Schwartz, “When You Assume . . . Rearranging Liabilities in Corporate Reorganizations,” The Tax Club (Nov. 2001)

L. Sheppard, “Dissecting Partnership Gambits for Rich People,” 96 Tax Notes 22 (July 1, 2002)

J. Kwall, “Out with the Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales,” 81 N.C. L. Rev. 977 (March 2003)

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NYS Bar Ass’n Tax Section, Report No. 1051, Report on Treatment of Variable Stock Consideration in Tax-Free Corporation Reorganizations” (Feb. 4, 2004), 2004 TNT 25-12

M. Silverman, M. Lerner & G. Kidder, “The Economic Substance Doctrine: Sorting Through the Federal Circuit’s ‘We Know It When We See It’ Ruling in *Coltec*,” The Tax Executive (November - December 2006)

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J. Cummings, “Economic Substance Doctrine Defense Plan,” 130 Tax Notes 953 (Feb. 21, 2011)