CONTINGENT CONSIDERATION AND CONTINGENT LIABILITIES IN ACQUISITIONS

OUTLINE

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NOMENCLATURE

The following terms are used in this outline:

Target	=	Corporation whose assets are sold to Acquiror (or, sometimes "Seller"); or corporation whose stock is sold (with or without a section 338(h)(10) election); or corporation whose stock or assets are acquired by Acquiror in a tax-free reorganization.
Old T	=	Deemed seller of assets in a section 338(h)(10) stock sale.
New T	=	Deemed purchaser of assets in a section 338(h)(10) stock sale.
Seller	=	Seller of assets of a business (or, sometimes "Target"); or seller of Target stock (with or without a section 338(h)(10) election).
Acquiror	=	Purchaser of assets from Target; or purchaser of Target stock (with or without a section 338(h)(10) election) from Seller; or corporation acquiring Target stock or assets in a tax-free reorganization.
Parent	=	Parent corporation of Acquiror.
Closing	=	Effective date of a sale for tax purposes.
Current 338 Regulations	=	Reg. §§ 1.338-0 through 1.338-7, 1.338-10, 1.338(h)(10)-1 and 1.1060-1, as in effect after March 16, 2001, T.D. 8940, 66 Fed. Reg. 9,925 (Feb. 13, 2001), corrected, 66 Fed. Reg. 17,362 (March 30, 2001).
Old 338 Regulations	=	Reg. §§ 1.338-0 through 1.338(b)-1, 1.338(b)-2T, 1.338(b)-3T, 1.338(h)(10)-1, 1.338(i)-1 and 1.1060-1T, as in effect until January 5, 2000 (cited as "Old Reg. §").

INTRODUCTION

All business acquisitions have loose ends. Often there is a contingent purchase price like an earn-out or escrow. Even more often, at the time of closing it is not possible to identify and quantify all the costs that have been incurred in the business and all the claims that may be asserted against the business. Open items might include costs for environmental remediation, deferred compensation and other employee benefits (vested or non-vested), tax deficiencies, product liability and warranty claims and contract or tort claims. Acquiror may assume the obligation to pay these costs and claims, or Seller may be financially responsible, directly or through indemnities. This outline discusses the tax consequences of these loose ends.

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

- If Acquiror agrees to pay contingent consideration for the business, the tax treatment of Seller and Acquiror are not consistent. Unless Seller elects the installment method or is eligible for the "open transaction" method, Seller must use the "closed transaction" method and include the estimated present value of future contingent purchase price payments in its amount realized at the closing. In general, however, Acquiror may not deduct these payments or include them in the basis of the purchased assets until the amounts become fixed and determinable and are paid. Even then, Acquiror may have to capitalize these payments and allocate them to goodwill with 15-year amortization (beginning at closing), rather than deduct them currently.

- Under prior regulations, in effect until January 5, 2000, a consolidated group that sold a business generally was better off selling the stock of a subsidiary and making a section 338(h)(10) election, as opposed to having the subsidiary actually sell its assets. In an asset sale, Seller generally had to report a closed transaction, but in a stock sale with a section 338(h)(10) election Seller and Target were entitled to use the open transaction method and delay reporting the contingent purchase price until received. On the other hand, the selling group in a section 338(h)(10) stock sale was not eligible for the installment method.

- Under the current regulations the discrepancy in treatment between an actual asset sale and a stock sale subject to a section 338(h)(10) election has been eliminated. In a section 338(h)(10) stock sale, Target is treated as though it had actually sold assets. As in an actual asset sale, the closed transaction method is the general rule, but in either case the installment method is available.

- In either an actual asset sale or a section 338(h)(10) stock sale, the open transaction method is available in "rare and extraordinary" cases. This method allows gain to be deferred until contingent payments are received, while (apart from imputed interest) allowing all the basis of the assets sold, or deemed sold, to be recovered against the first proceeds received.

- The installment method often results in less tax deferral to Seller than one might suppose, due to asset basis being recovered against payments received in the future. The installment method may actually result in acceleration of tax.

- In the open transaction method, losses are deferred until all contingent consideration is received. Thus, the presence of loss and gain assets in the same transaction can cause distortion where this method is used.

- Under the closed transaction method, if Seller is entitled to contingent consideration, it must report the estimated present value of these payments as amount realized at closing. If Seller receives with more or less than this estimated amount, it is not clear whether the difference (apart from imputed interest) is ordinary income or loss or capital gain or loss.
- Under the closed transaction method, if Acquiror assumes contingent liabilities, Seller may have to report, as amount realized at closing, the present value of the assumed liabilities. The open transaction method may be available for assumed contingent liabilities where the requirements for this method are met. It is surprising, in view of how common this situation is, that this result is not clear.
- There are often deductions for Seller to offset the gain on Acquiror's assumption and payment of contingent liabilities. These deductions may or may not be available, however, at the same time as the gain recognition. Again, the lack of definitive guidance is surprising.
- Seller may have to continue to follow the fortunes of the sold business, even if it is not liable for contingent liabilities. Payment of assumed liabilities by Acquiror or Target may result in additional taxable gain from the sale.
- Acquiror must capitalize rather than deduct many post-closing expenditures relating to a business it has acquired, including some that seem routine or that result from surprises after Closing. If Acquiror's obligation to make these expenditures is contingent at closing, Acquiror is not allowed any depreciation deductions for these capitalized amounts until the all-events test and the economic performance tests are met (usually when payment occurs).
- It is unlikely but possible that *Acquiror* will have to recognize taxable income at closing to account for contingent liabilities assumed *by it*, with an offsetting loss when the liabilities become fixed and are paid.
- In a taxable stock sale without a section 338(h)(10) election, if Target has contingent liabilities that are retained by Seller (*e.g.*, through indemnities), two deductions may result – a capital loss to Seller and an ordinary deduction to Target – with no offsetting income or gain to Acquiror, Seller or Target.
- If a loss (even a real economic loss) is recognized on a sale of stock of a consolidated subsidiary Target, the Target's tax attributes (loss carryovers, asset basis, etc.) may be reduced after the sale, to prevent duplication of tax benefits. Acquiror will bear this burden. If the loss is due to a contingent liability paid after the stock sale, the tax attributes are reduced when the liability is taken into account.
- Under proposed regulations published in 1999 and not revisited since that time, in a taxable acquisition if part of the purchase price is placed into escrow, Acquiror would be taxed on income earned on the escrowed funds until it is determined which party will receive the funds. Acquiror would be taxed on this income even if the income is actually paid to Seller out of the escrow. If a dispute develops, and the funds come under court jurisdiction, then, under final regulations, the escrow fund would be taxed as a separate entity.
- On the other hand, escrowed Acquiror stock in a tax-free acquisition is considered to belong to the former Target shareholders, and any dividends paid on the escrowed stock are taxed to those shareholders.

- In a tax-free reorganization with contingent stock (as opposed to escrowed stock), imputed interest is taxed to the former shareholders. This imputed interest may or may not be deductible to Acquiror. Dividends on the contingent stock, however, are not taxed to the former Target shareholders if not actually paid to them.
- Contingent liabilities may affect whether an acquisition can qualify as a tax-free reorganization. If Target's contingent liabilities are large enough so that, together with fixed liabilities, the amount of liabilities is greater than the fair market value of its assets, then, under proposed regulations, no tax-free reorganization would be possible. The proposed regulations do not, however, explain how to compute Target's contingent liabilities for this purpose. The same rules would apply to asset transfers to corporations under sections 351 and to corporate dissolutions under section 332.

TAXABLE ASSET AND STOCK ACQUISITIONS

I. Contingent Purchase Price in Acquisitions of Target Assets and Acquisitions of Target Stock Without Section 338(h)(10) Elections

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

The Seller of assets or Target stock in a taxable acquisition with contingent purchase price reports gain (but not loss) on the installment method, unless Seller elects out. The installment method does not apply to a contingent payment obligation, if the obligation represents a retained interest in the property, an interest in a joint venture or partnership or equity in a corporation. Reg. § 15a.453-1(c)(1); *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976) (no joint venture when Seller indemnified Acquiror for earnings shortfall). For a summary of the advantages and disadvantages of the installment method, *see* part I.C.6., below.

B. Treatment of Seller – Election Out of Installment Method

1. Amount Realized at Closing

a. General Rule: Closed Transaction

If Seller elects out of the installment method, then, as a general rule, Seller must use the "closed transaction" method and include the fair market value of the right to contingent purchase price in its amount realized at closing. Reg. § 1.1001-1(g)(2). In TAM 9853002 (undated), IRS compared this result to the results under the installment method, taking the deferral charge of section 453A into account. IRS concluded that the results under the installment sale method and the closed transaction method should be economically comparable. *See* part I.C.3.b., below.

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

b. Open Transaction – General

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

c. Open Transaction – Advantage Over Other Methods

In sales where gain is recognized, the open transaction method is usually advantageous, as compared with both the generally-applicable closed transaction method (*see* part I.B.1.a., above) and the installment method (*see* part I.C., below). Under the open transaction method, the basis of the assets sold may be recovered tax-free, with gain being recognized only after full basis recovery. The only exception is that, under Reg. § 1.483-4, a portion of each actual payment is treated as ordinary interest income received by Seller and currently-deductible interest paid by Acquiror. There is no original issue discount or other taxable or deductible accrual of interest. This treatment contrasts with the treatment of "contingent payment debt instruments," in financial transactions. Under Reg. § 1.1275-4, these instruments accrue interest at a "comparable yield" for noncontingent debt.

d. Open Transaction – Losses

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

It may be possible to prevent this acceleration of tax by allocating cash or other fixed consideration to high-basis assets and the open-transaction contingent consideration to lower-basis assets. Section 1060 does not prohibit special allocation of types of consideration to different assets, even if they are sold as part of an "applicable asset acquisition" subject to the residual method, but PLR 200004040 (Oct. 24, 1999) suggests that IRS has doubts as to whether such an allocation is proper. The authorities are discussed in part I.C.5., below, in the context of an installment sale.

e. Open Transaction – Limited Applicability

The open transaction method applies only if the contingent purchase price obligation received by Seller cannot be valued. The courts have been reluctant to accept an assertion that property received by a taxpayer cannot be valued. Cases involving stock options illustrate this principle. When these options are received as part of a sale price, their value is generally taken into account at the time the options are granted (not, as in compensation arrangements, when exercised). *Custom Chrome, Inc. v. Commissioner*, 217 F.3d 1117 (9th Cir. 2000), *aff'g in part and rev'g in part* T.C. Memo 1998-317 (warrants issued to lender valued at time loan was made and included in original issue discount). *See also Computervision Int'l Inc. v. Commissioner*, 1996 T.C. Memo

131 (1996); *Sun Microsystems Inc. v. Commissioner,* 1993 T.C. Memo 467 (1993) (warrants represented sales discount whose value was excludable from gross income but taken into account in basis of purchased equipment); *Centel Communications v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990) (warrants issued in recognition of loan guarantees not subject to section 83; issuer not entitled to deduction, no ordinary income to holders on exercise); *Monarch Cement Co. v. United States*, 634 F.2d 484 (10^{th} Cir. 1980), *aff'g* 458 F. Supp. 384 (D. Kan. 1978) (stock warrants issued in connection with a note treated as discount amortizable over the term of loan; warrants valued at time of loan); TAM 200043013 (Oct. 30, 2000) (warrants issued to bank in connection with bankruptcy reorganization not transferred in connection with services performed by bank; if warrants have value at time of issuance, there is original issue discount on loan by bank deductible over the life of loan); TAM 9737001 (May 23, 1997) (section 83 did not apply to warrants issued to cable companies in connection with affiliation agreements providing channel access; warrants were not granted in connection with services but as an inducement to obtain more channel access). *Compare Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (offsetting put and call options on stock not treated as current sale of stock because of differences in terms); Rev. Rul. 85-87, 1985-1 C.B. 268 (sale of stock at a loss coupled with sale of "in-the-money" put on the same stock; put treated as contract to acquire the stock and caused loss to be disallowed under wash sale rules). *See* part IX., below, for discussion of stock options received in tax-free acquisitions.

f. Open Transaction – Royalty Transactions

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

g. Stock Sale – Possible Treatment of Contingent Purchase Price Obligation as Target Stock

Depending on its terms, a right to contingent purchase price payments could be treated as stock of the Acquiror or as stock of the Target retained by the Seller, *e.g.*, if the contingent purchase price is tied to increases in the value of the business. This analysis would not make much difference in a sale of assets, except that it would eliminate the open transaction method. (Conceivably, it could convert the sale to a tax-free reorganization.) In the case of a sale of Target stock, as opposed to assets (deemed or otherwise), however, the contingent payment obligation could be treated as a new class of Target stock that was (i) received by Seller in exchange for some of the historically-owned Target stock, in a tax-free recapitalization, and (ii) retained when Seller sells the rest of the Target stock. This treatment would prevent Seller from having to include the value of the contingent purchase price in its amount realized at closing. The contingent feature should prevent this "stock" from being nonqualified preferred stock (section 351(g)), taxable on receipt under section 354(a)(2)(B). *See also* part I.B.6., below.

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

One commentator has concluded that *Burnet v. Logan* provides only weak support for an open transaction method, and that this method cannot be justified. J. Kwall, "Out With the Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales," 81 N.C. L. Rev. 977 (March 2003). This commentator argues that earn-outs and similar arrangements should be treated as though Seller had sold part of its business and kept the rest, *e.g.*, as a partnership interest. This treatment would replace both the open and closed transaction methods and the installment method too. The main results would be that (i) no gain or loss would be recognized on the portion of the business deemed retained; (ii) the basis of that portion of the business would not be taken into account in the sale; (iii) the contingent payments (presumably, less the remaining basis) would be ordinary income to Seller when accrued or received; (iv) the contingent payments would be excluded from Buyer's income; and (v) all of Seller's basis in the portion of the assets sold would be recoverable against the fixed sale price, without allocation. It is not clear how such a system would work in the case of a stock sale.

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

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

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

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

j. Recent Cases Reaffirming Open Transaction Method

(1) *Fisher v. United States*

Fisher v. United States, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Ct. Fed. Cl. 2008), deals with the demutualization of a life insurance company. A policyholder retained his life insurance policy and received cash in lieu of stock of a new holding company for his equity interest in the former mutual. IRS argued that none of the policyholder's basis in his policy could be allocated to his equity interest in the mutual, because that equity interest had only speculative value. The court rejected this argument and turned the argument on its head. The court held that the policyholder could recover *all* of his cost basis in the policy before recognizing *any* taxable gain. The court relied on open transaction principles that allow full basis recovery against uncertain receipts and cases involving sales of easements and other partial interests in land. The opinion also casts doubt on the rationale for the regulation stating that the open transaction doctrine applies "only in rare and extraordinary cases." Reg. § 1.1001-1(a).

(2) *Anschutz Co. v. Commissioner*

In *Anschutz Co. v. Commissioner*, 135 T.C. No. 5 (2010), the taxpayer owned a large block of publicly-traded stock that was highly appreciated in value. It raised funds by entering into a "prepaid variable forward contract" to sell the stock to a securities dealer 10 years in the future and a "share lending agreement." The dealer made an upfront cash payment to the taxpayer totaling 80% of the value of the stock; the taxpayer pledged and delivered the stock as collateral for the upfront payment and lent the stock to the dealer. The taxpayer was entitled to payments in lieu of dividends on the stock and was also entitled to retain 50% of any appreciation on the stock above a threshold amount. The court held that the agreements, together, constituted a currently-taxable sale of the stock. (*See also Calloway v. Commissioner*, 135 T.C. No. 3 (2010), and *Samueli v. Commissioner*, 132 T.C. No. 4 (2009).)

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

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

The court did not explicitly state that the future contingent payments were contingent sale price, or that the sale was an open transaction. Nor did the court state a conclusion as to the treatment of the contingent payments. The result of the court's analysis, however, seems to be that the sale was an open transaction, and that any contingent payments would be taxed as additional sale proceeds and imputed interest upon receipt.

2. Contingent Payments Received After Closing – Closed Transaction Method

a. Principal Amounts – General

The theory of Reg. § 1.1001-1(g)(2) is that, at closing, as the amount realized for its assets, Seller receives the fixed purchase price plus a separate item of property – the right to contingent payments in the future. Seller is to report at closing the fair market value of its right to future contingent purchase price payments and take basis in the contingent payment right equal to this amount. As contingent payments are received, they are allocated between principal and interest under section 1274 or section 483, whichever applies. *See* parts I.B.2.b. and c., below. The amounts allocated to principal are tax-free return of capital up to the basis of the contingent payment right. Any excess of contingent principal payments over basis is gain. If the payments are less than the basis when the right expires, the excess basis is a loss. *See* part I.B.1.a., above.

b. Principal and Interest – Section 1274

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

c. Principal and Interest – Section 483

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

d. Principal Amounts – Character of Gain or Loss – Stakes

Is the gain or loss on the contingent purchase price payment right (part I.B.2.a., above) ordinary income or capital gain? The answer can be important, especially if there is gain at closing but a loss when the contingent payment right expires (because the contingent payments received amount to less than the value of the right to receive the payments at the closing date). If the loss on the contingent payment right is capital loss, and if this loss is recognized more than three years after the closing (five years, for losses recognized in 2001 and 2002), it cannot be carried back to shelter capital gain on the asset sale. This loss could become unusable unless Seller has other capital gains.

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

(1) Adjustment to Purchase Price

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

(2) Closed Transaction

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

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

(1) Gain

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

(2) Loss

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

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

(a) "Debt Instrument" Defined

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

(b) Debt vs. Equity

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

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

A right to contingent purchase price payments could be characterized, not as a debt instrument or an equity interest issued by Acquiror, but instead as a contractual right against Acquiror. If so, determining whether the gain or loss is ordinary or capital entails a complex case law inquiry, also taking section 1234A into account. The 1997 revision of section 1234A seems to dictate "sale or exchange" treatment when the contingent payment right is satisfied (thus suggesting capital gain or loss), but the scope of this provision is uncertain. For a review of the case law on the character of income from payments to extinguish or transfer contract rights, *see* N. Schmelzer, "Taxation of Transfers of Contract Rights," 98 Tax Notes 228 (Jan. 13, 2003). For an extended discussion arguing that gain on a contingent payment right is ordinary income and citing extensive case law, *see* J. Kwall, "Out With The Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales," 81 N.C.L.Rev. 977 (2003), discussed in part I.B.1.h., above.

(1) Issues

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

(2) The Courts' Approach

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

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

(a) Historical Approach – the Extinguishment Doctrine

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

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

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

(b) *Commissioner v. Ferrer*

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

(c) The Importance of *Ferrer*

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

(d) The Courts and IRS Distinguish *Ferrer*

Even after *Ferrer*, the courts and IRS continued to apply the extinguishment doctrine in some instances. As examples, in *Billy Rose's Diamond Horseshoe, Inc. v. Commissioner*, 448 F.2d 549 (2d Cir. 1971), a lessee paid its lessor to release the lessee from an obligation to restore the leased premises. The court denied the lessor use of installment sale method under section 453, because there was no sale of property, citing *Pittston* for the proposition that a release of a contract right is not a sale. The court distinguished *Ferrer* on the ground that the rights to the play there were transferable (even though not actually transferred) to a third party. (Can *Billy Rose* be explained by the character of the released right not being an interest in underlying property and so not a capital asset?) IRS also seemed to adopt extinguishment in Rev. Rul. 75-527, 1975-2 C.B. 30 (no sale, and so no capital gain, upon release of right to heat a building, because right was extinguished rather than being "passed" to another party).

(e) Section 1234A Codifies *Ferrer*

Section 1234A treats a cancellation, lapse, expiration or other termination of a right or obligation with respect to certain property which is (or would be upon acquisition) a capital asset in the hands of the taxpayer as a "sale or exchange." H.R. Conf. Rep. No. 105-220 at 454 (1997). As originally enacted in 1981, section 1234A applied only to actively traded personal property and futures contracts. P.L. 97-34, § 507; P.L. 97-448, § 105. Section 1234A was expanded in 1984 and again in 1997, and it now applies to all types of property – so long as the underlying property is a capital asset. This extension was necessary due to Congress's perception that similar transactions were receiving inconsistent treatment. S. Rep. No. 33, 105th Cong., 1st Sess. 132, 133 (1997). The legislative history further states that the amendment to section 1234A –

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

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

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

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

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

In support of this conclusion, IRS relied principally on *Wolff v. Commissioner*, 148 F.3d 186 (2d Cir. 1998), and *Nahey v. Commissioner*, 111 T.C. 256 (1998), *aff'd*, 196 F.3d 866 (7th Cir. 1999). In *Wolff*, the court held that a fee paid to cancel one leg of a commodity forward contract was an ordinary loss to the payor, due to lack of a sale or exchange. However, as IRS noted, the transaction in *Wolff* occurred before enactment of even the original section 1234A. Further, a burdensome contract is more like a liability than "property," and so a payment to cancel such a contract may generate an ordinary deduction to the payor, regardless of its treatment to the recipient. *See* part I.B.2.g.(3)(g), below. *Nahey* supports the extinguishment doctrine, but, like *Wolff*, *Nahey* arose under a prior version of section 1234A that did not encompass the transaction. The *Nahey* opinion employs the extinguishment doctrine but does not discuss section 1234A. If the *Nahey* transaction occurred today, it would seem to fall within section 1234A, which would require reconciling the extinguishment doctrine with that section, a task that seems impossible. Because neither of the *Nahey* courts had any reason to attempt this reconciliation, *Nahey*'s support for the extinguishment doctrine is dubious, and IRS's reliance on it for that purpose seems misplaced. In *Nahey*, the taxpayer bought the assets of a business, including a claim in a pending lawsuit involving lost income, and later settled the lawsuit at a gain. (None of the purchase price was allocated to the claim.) The Tax Court concluded that the proceeds were ordinary income, because the settlement extinguished the claim and so no sale or exchange occurred. The Tax Court distinguished *Ferrer* on the basis that, whereas the claim in the lawsuit "vanished in both form and substance upon the receipt of the settlement proceeds," Ferrer's "interest (or lease) to produce the play and prevent the author's transfer of film rights did not disappear but instead reverted to the author after [Ferrer] surrendered the lease . . ." This distinction is not easy to discern. The Seventh Circuit took an entirely different approach to the same result:

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

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

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

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

(h) Conclusion

Despite TAM 200049009 and TAM 200427025 (discussed in part I.B.2.g.(3)(f), above), the best interpretation seems to be that the extinguishment doctrine should not determine the character of gain or loss on payments of contingent purchase price. In other words, if a contractual right either *changes hands* or *is surrendered*, the transaction is probably a "sale or exchange" for section 1221 purposes. The only remaining issue would be whether the contract right itself constitutes a capital asset.

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

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

a. Whether the Rights are Incidental to or Create an Estate in Property

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

b. Whether the Rights Can Appreciate or Depreciate in Value

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

c. Whether the Right Entails Goodwill

The fact that part of the value of a contractual right is traceable to goodwill suggests that a transfer of the contract involves an underlying asset, not just a right to receive future income. As a result, capital gain or loss is more likely. *Bankers Guarantee Title & Trust Co. v. United States*, 418 F.2d 1084 (6th Cir. 1969); *Brisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (5th Cir. 1963); *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (1962) (sale of right to service life insurance contracts included a property right which was the equivalent of goodwill, and capital gain treatment resulted).

d. Whether the Taxpayer Made a Capital Investment and Has Basis

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

e. Whether the Rights Originated with the Holder

The fact that a contractual right originated with the holder suggests that the underlying value is due to personal service, which yields ordinary income. If the right originated with a third party, however, the holder more likely holds it as an investment. *Compare Miller v. Commissioner*, 299 F.2d 706 (2d Cir. 1962) (wife of band leader Glenn Miller denied capital gain on sale of production rights to movie about her husband), *with Ferrer* (capital gain on sale of rights to play written by another playwright). *But see Nahey v. Commissioner*, discussed in part I.B.2.g.(3)(f), above (collection in settlement of purchased lawsuit claim ordinary income, because collection by seller would have ordinary income).

f. Whether the Taxpayer Parted with All its Rights

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

g. Whether Transfer of Contract Rights Merely Substitutes Source of Ordinary Income

If the proceeds of a transfer substitute for what would have been ordinary income to the seller, most courts conclude that capital gain is unavailable. Examples include a payment by a lessee to its lessor to terminate a lease (Reg. § 1.61-8(b)); a sale of a right to collect previously-accrued income (*Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962); *Fisher v. Commissioner*, 209 F.2d 513 (6th Cir. 1954)); a right to film royalties (*Lasky v. Commissioner*, 22 T.C. 13 (1954)); a share in profits from a mining venture (*Ayrton Metal Co., Inc. v. Commissioner*, 299 F.2d 741 (2d Cir. 1962)); and a right to declared but unpaid dividends (*Rhodes Est. v. Commissioner*, 131 F.2d 50 (6th Cir. 1942)). Transactions involving personal services generally result in ordinary income. *Flower v. Commissioner,* 61 T.C. 140 (1973) (right to promote pharmaceutical products); *Maryland Coal & Coke Co. v. McGinness*, 350 F.2d 293 (3d Cir. 1965) (right to sell output of a mine); *Lozoff v. U.S.*, 266 F. Supp. 966 (E.D. Wis. 1967) (right to act as a purchasing agent); *Foote v. Commissioner*, 81 T.C. 930 (1983) (amounts paid to taxpayer by college in consideration of his relinquishment of tenure as professor were ordinary income).

h. Treatment of Principal Amounts – Is Gain or Loss on a Right to Contingent Purchase Price Payments Capital or Ordinary?

(1) Right to Payments as Debt Instrument

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

(2) Right to Payments as Contract Right – Capital or Ordinary?

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

(3) Effect of Section 1234A

Section 1234A may or may not change this outcome. Even though it mandates "sale or exchange" treatment for "cancellation, lapse, expiration or other termination" of a contractual right, payment under the terms of the contract itself may be a fulfillment of the right, not a cancellation, etc. Query whether the language in section 1234A is meant to have a narrower meaning than "retirement," as used in section 1271(a), relating to debt instruments. Even if section 1234A does apply, there remains the question whether the right to contingent purchase price payments itself is a capital asset. For discussion of an analogous issue, *see* M.A. Stevens, "The Tax Treatment of Contingent Options," 102 Tax Notes 535 (Jan. 26, 2004) (pointing out that a premium received in payment for a contingent option may be taxable when received, even though a premium received for a non-contingent option is taxed only when the option either is exercised or expires).

(4) Consequences of Uncertainty

The complexity of this issue and the uncertainty of the outcome are, of course, undesirable to taxpayers trying to plan acquisitions. The same situation creates planning opportunities, however, such as allowing taxpayers to report capital gain where there is gain and ordinary loss where there is loss. This uncertainty compounds the uncertainty as to whether open transaction treatment is available in gain situations and creates yet more incentive to taxpayers to use the open transaction method when possible.

3. Contingent Payments After Closing – Open Transaction Method

In the "rare and extraordinary" case where Seller's contingent payment right is not susceptible to valuation, the transaction remains open, and, when the amounts become includible under Seller's method of accounting, Seller discounts the amount (to determine interest and principal) and has additional amount realized on the sale, plus interest income. *See* part I.B.1., above.

4. Sale for Private Annuity

For many years, a variant of the open transaction method has been available to an individual who sells a appreciated property for a private annuity on the seller's life. The current IRS guidance states that Seller's amount realized on the sale is the present value of annuity, based on annuitant's life expectancy, but that taxable gain is deferred and is taxed ratably over Seller's life expectancy The restrictions on the installment method and the section 453A deferral charge do not apply. Rev. Rul. 69-74, 1969-1 C.B. 43. For an example of such a transaction, *see Katz v. Commissioner*, T.C. Memo. 2008-269. In 2006, however, regulations were proposed to eliminate this special benefit and to tax sales for private annuities under the closed transaction method. The installment method would be available subject to normal exclusions and restrictions, including the deferral charge. The proposed regulations would take effect for sales after October 18, 2006, but if specified conditions are satisfied only after April 18, 2007. Prop. Reg. § 1.1001-1(j) (2006). Notice of Proposed Rulemaking REG-14901-05 RIN 1545-BE92, 71 Fed. Reg. 61441 (Oct. 18, 2006).

5. Allocation of Amounts Realized Among Assets Sold

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

6. Possible Treatment of Contingent Purchase Price Obligation as Target Stock

As discussed in parts I.B.1.g. and I.B.2.f.(3)(b), above, a contingent purchase price right could be treated as Target stock, if its terms make it an equity interest in Target. If, in a sale of Target stock, the right is treated this way, Seller would be treated as retaining this Target stock. If so, as contingent payments are made, the payments would be treated as redemptions of this stock, taxed as sale proceeds or as dividends under section 302. Generally, this treatment would be similar to installment sale treatment, because the deemed redemption payments would be taxed as received. More important, this deemed retention of Target stock could prevent the transaction from being a "qualified stock purchase" under section 338(d)(3) (more than 80% of vote and value must be acquired by purchaser within a 12-month period).

C. Treatment of Seller – Installment Method

1. Application

Installment method reporting applies to gain on a sale with a contingent purchase price if at least one payment is to be received after the taxable year of the closing. But the installment method does not apply to losses, which must be taken in the year of sale under the closed transaction method or later if the open transaction method is used. *See* part I.B.1., above. Sales of certain property, such as publicly traded securities and depreciable property to the extent of recapture, are also ineligible for the installment method. I.R.C. §§ 453(f)(2), (f)(7). Thus, installment method reporting requires an asset-by-asset determination on availability. Most believe that an assumption by Acquiror of contingent liabilities, without more, makes a sale eligible for the installment method. *See* parts I.C.4.d.(1), I.C.4.e.(5) and IV.D., below.

2. Election

If a sale is eligible, installment method reporting is automatic unless Seller elects out by reporting the full gain on a timely filed return (including extensions). Presumably, a return that reports a sale on the open transaction method also constitutes an election out of the installment method. *See* part I.E.3., below.

3. Deferral Charge

a. General

If Seller has more than $5 million deferred gain from installment sales, Seller is subject to an interest-type deferral charge at the underpayment rate (Federal short-term rate plus three percentage points). I.R.C. § 453A. Thus, in a large transaction Seller usually obtains little or no advantage from the installment method.

b. TAM 9853002 and its Implications

(1) TAM 9853002 Described

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

(2) Rationale

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

(3) Maximum Selling Price or Fair Market Value?

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

4. Method of Calculating Gain Recognized

a. General

If the installment method is used, gain is recognized as each payment is received. Generally, the amount of gain allocable to each payment is determined under section 453(c) by allocating basis in proportion to the amounts of the principal payments to be received. The treatment of a contingent payment under the installment sale rules depends on whether the contingent payment is limited as to amount, as to timing, or neither. Most commonly, there is a cap on the amount of the contingent payments. In this case, basis recovered against each payment is computed as though the maximum amount were to be received at the earliest date. If payments of contingent liabilities by Purchaser are considered part of the purchase price, the installment sale method would apply and force delay in Seller's recovery of a portion of its basis until the payments are received. The open transaction method generally is more favorable than the installment method, because the open transaction method avoids valuation problems and permits delaying taxable gain until all basis has been recovered. Under the Old 338 Regulations, the open transaction method was readily available in the context of a stock sale with a section 338(h)(10) election, but the Current 338 Regulations eliminate this advantage. *See* parts II.B.2.a., II.B.2.b. and II*.A.2., below.

b. Amount Realized at Closing

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

c. Amount Realized Upon Receipt of Payment

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

d. Allocation of Amounts Realized Among Assets Sold

The total selling price, including the contingent payment obligation, is allocated among all assets, tangible and intangible, under the residual method described in Reg. § 1.1060-1. But different forms of consideration may be specially allocated. *See* part I.C.5., below.

(1) Increases in Purchase Price

Under section 1060, increases in Seller's consideration received (its amount realized) are allocated among assets under the residual method. Reg. §§ 1.338-6(b) and 1.338-7, cross referenced in Reg. § 1.1060-1(c)(2). The same treatment applies to payments by Acquiror of assumed contingent liabilities that are treated as purchase price adjustments. This treatment seems to mean that every acquisition of a business with contingent liabilities is an installment sale. *See* parts I.C.4.e.(5), II.B.1.b. and IV.D., below.

(2) Decreases in Purchase Price

Decreases in consideration received by Seller are allocated in reverse section 1060 order: first to goodwill (Class VII), then to other intangibles (Class VI), etc. Reg. §§ 1.338-6(b) and 1.338-7, cross referenced in Reg. § 1.1060-1(c)(2). However, no refund of section 453A deferral charge is allowed. *See* part I.C.3.b., above. An example of a decrease in purchase price is an indemnity payment made by Seller to Acquiror for a breach of a covenant, warranty or representation. *See* parts V.D. and V.E., below.

e. Recovery of Asset Basis

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

(1) Maximum Selling Price

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

(2) Time Limitation

If no maximum selling price can be determined, but the contingent payment is limited to a specific time period, basis is generally recovered in "equal annual increments" during the time contingent payments can be received. Reg. § 15a.453-1(c)(3). If a payment received in any one year is less than the basis allocated for that year, there is no loss allowed, and instead the amount of unrecovered basis is carried forward to the following year. Reg. § 15a.453-1(c)(3). *Cf. Schmidt v. Commissioner*, 55 T.C. 335 (1970) (no loss to shareholder on corporate liquidation until complete).

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

(3) No Maximum Selling Price or Time Limitation

If contingent payments are not limited by a fixed period or maximum selling price, the transaction is analyzed to determine whether, in substance, a sale occurred, and the payment is a debt from Acquiror to Seller (rather than an equity stake in Acquiror or Target). If so, basis generally is recovered ratably over 15 years. Reg. § 15a.453-1(c)(4). No loss is permitted until the transaction ultimately closes. Basis in excess of the amount of a payment in any given year is carried forward to the next year, and to future years if necessary, until it is applied against proceeds or the future payment obligation is determined to be worthless. Reg. § 15a.453-1(c)(4). Seller may try to convince IRS that the straight line allocation inappropriately defers recovery of

Seller's basis, although there is the risk that IRS might lengthen the recovery period as well. The test is whether the straight-line allocation "would substantially or inappropriately defer or accelerate" recovery.

(4) Impact of Loss Assets, Etc.

Losses are not deferred under the installment method. Nor are gains on sales of inventory, depreciation recapture, etc. *See* part I.C.1., above.

(5) Impact of Assumed Contingent Liabilities

If Acquiror assumes contingent liabilities in an asset purchase, the assumption is probably contingent purchase price that would invoke the basis recovery rules of the installment sale method. *See* part I.C.4.d.(1), above, and parts II.B.1.b. and IV.D., below. For example, if Acquiror assumes Seller's contingent liabilities with no cap or time limit, it appears that Seller must recover its asset basis over 15 years, unless it either receives IRS permission to do otherwise or elects out of the installment method?

f. Character of Amounts Realized – Actual and Imputed Interest

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

5. Allocating Installment Obligation to Certain Assets

Seller may be able to allocate contingent consideration to assets on which the installment method would provide the most benefit – *e.g.*, allocate contingent consideration to goodwill and going concern value (which may have a zero basis) and the cash portion of the purchase price to hard assets, or contingent consideration to gain assets and cash to loss assets. *Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq*. 1964-2 C.B. 6; Rev. Rul. 68-13, 1968-1 C.B. 195. This ability to recover more basis against cash purchase price payments would make the installment method more attractive. PLR 200004040 (Oct. 24, 1999), however, suggests that, in an asset purchase under section 1060, different forms of consideration may not be allocated to different assets in an acquisition. The ruling states that consideration should be treated as paid for the assets as a whole and allocated solely by reference to the scheme described in the regulations for sections 338 and 1060, *i.e.*, class by class. Moreover, even if IRS is incorrect as to actual asset sales under section 1060, it is not clear how different forms of consideration would be allocated differently to different assets in a section 338(h)(10) stock sale.

6. Advantages and Disadvantages of Installment Sale Method to Seller

a. Advantages

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

b. Disadvantages

The biggest detriment in the installment method is the section 453A deferral charge for obligations greater than $5 million. Even in a transaction that generates a less-than-$5 million obligation, however, Seller may find the installment method disadvantageous. This would occur, for example, if the maximum selling price considerably exceeds the amount actually paid after resolution of the contingencies, causing basis recovery to be delayed (*but see* part I.C.5., above). There may not be much advantage to installment reporting over closed transaction treatment, and open transaction treatment is often much more advantageous.

D. Treatment of Acquiror

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

1. Allocation of Contingent Purchase Price Among Assets Purchased

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

a. Increases in Purchase Price

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

b. Decreases in Purchase Price

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

2. Specific Allocations – Intangible Assets

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

3. Timing of Effects on Basis and Interest Deductions

When a contingent payment of purchase price is made, the payment is apportioned between principal and interest. Acquiror discounts the payment using the same section 483 or section 1274 rules that apply to Seller. *See* part I.B.2., above. Acquiror deducts the interest portion and adds the principal portion to its basis in the assets or stock purchased. Note the asymmetry between Acquiror's and Seller's treatments. Acquiror is entitled to make an upward basis adjustment only upon making an additional purchase price payment to Seller. Reg. §§ 1.461-1(a)(1), (2). Because the "space beneath" the fair market value cap of the Class II to Class V assets is likely to have been filled, the increased basis adjustment generally will be made to intangibles (Classes VI and VII), recoverable over the remainder of the 15-year amortization period from the date of sale.

4. Contracts for Use of Intangibles

Section 197 does not apply to amounts that are otherwise deductible. Reg. § 1.197-2(a)(3). Pre-section 197 case law suggests that, to the extent the purchase price paid for certain types of intangible assets pertains to a particular taxable year, the amounts paid are deductible in that year. *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945) (price of patent based on percentage of income each year); *Holden Fuel Oil Co. v. Commissioner*, T.C. Memo 1972-45, *aff'd*, 479 F.2d 613 (6th Cir. 1973) (contingent payments for customer list deductible when paid). Under *Associated Patentees*, Acquiror could claim an immediate deduction for additional purchase price payments tied to performance of the intangible during the taxable year, irrespective of the 15-year amortization period under section 197. The section 197 regulations eliminate this argument, with certain exceptions. Reg. § 1.197-2(b)(11) includes in the definition of "section 197 intangible" licenses, contracts, etc., for the use of section 197 intangibles. Reg. § 1.197-2(f)(3) goes on to provide that amounts paid for the *use* of intangibles generally are not deducted currently but are instead amortized over 15 years. *See* part II.C.2.c., below.

5. Interest

As discussed in parts I.B.2.b. and c., above, part of the contingent purchase price paid by Acquiror is actual or imputed interest. Under original issue discount rules, this interest is deductible only when the amount of stated or imputed interest becomes fixed (accrual method) or when paid (cash method). Reg. § 1.461-4(e). On the accrual method, interest can be deducted even before economic performance on the principal portion of the contingent payment – *i.e.*, before the principal can be added to the basis of the purchased assets. Interest is generally not capitalized. An exception, section 263(g), applies only to straddles. If the assets acquired are not publicly-traded property, there can be no straddle, and the interest component is not capitalized. I.R.C. § 1092(d)(1).

6. Payment to Third Party

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

E. Reporting Requirements

1. Section 1060 Acquisitions

In an asset sale, Seller and Acquiror each must complete Form 8594, *Asset Acquisition Statement Under Section 1060* (Rev. Feb. 2006), and attach it to their respective returns for the year in which the sale takes place. If the amount allocated to any asset is increased or decreased after the form is filed, the parties must complete Part I and the supplemental statement in Part III of a new Form 8594 (allocating and explaining the reasons for the price increase or decrease) and attach it to the return for the year in which the increase or decrease is taken into account.

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

2. Installment Method

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

3. Installment Method – Electing Out

To elect out of the installment method, Seller reports the full amount of gain on a timely filed return (including extensions), using Form 4797, *Sales of Business Property*, or Schedule D for individuals. There is no specific procedure for electing out where the installment method applies only by virtue of assumption of contingent liabilities, or where the open transaction method is available. *See* part I.C.2., above.

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

A. Introduction

Section 338(h)(10) allows certain stock sales to be treated as though the target company ("Old T") had sold its assets to a new company ("New T") and then distributed the sale price to Seller, generally in liquidation.

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

Part II*., below, discusses the section 338(h)(10) and section 1060 regime under the regulations in effect before the temporary regulations (the "Old 338 Regulations," cited as "Old Reg. §"). Most commentators had concluded that, in a section 338(h)(10) transaction under the Old 338

Regulations, (1) the installment method was not available, but (2) if there was contingent purchase price or an assumption of contingent liabilities, open transaction treatment was allowed for Old T as well as being required for New T.

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

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

B. Treatment of Old T

1. Installment Method

Under the Current 338 Regulations, the installment method is available in the asset sale that is deemed to occur in a stock sale with a section 338(h)(10) election. Reg. § 1.338(h)(10)-1(d)(8). The overriding principle is that the transaction is treated as though it were an actual asset sale and liquidation. Reg. § 1.338-1(d)(3). Old T may not assert any position inconsistent with this principle. Reg. § 1.338(h)(10)-1(d)(9).

a. Acquiror's Installment Note

The Current 338 Regulations treat Old T as selling its assets to New T and treat the installment note issued by the purchaser of the Target stock as though it were New T's obligation. Reg. § 1.338(h)(10)-1(d)(8)(i). This treatment eliminates the technical bar to the installment method under the Old 338 Regulations (*i.e.*, the fact that the note is actually issued by the actual stock purchaser, Acquiror, not by the deemed asset purchaser, New T – *see* Reg. § 15a.453-1(b)(3)(i)).

b. Other Consideration Deemed Paid to Old T

All other consideration received by Old T in the asset sale is deemed paid in cash. For example, if Acquiror does not purchase all the Target stock, New T still is deemed to purchase all the assets of Old T at full fair market value. The excess of the deemed purchase price for the assets over the amount actually paid for the stock is deemed paid in cash. This rule also applies to assumed liabilities of the Target shareholders, but it does not apply to assumed liabilities of Target itself. Reg. § 1.338(h)(10)-1(d)(8)(i). Does this exclusion suggest that a deemed assumption by New T of a contingent liability of Old T turns the deemed asset sale into an installment sale? *See* parts I.C.4.d.(1) and I.C.4.e.(5)., above, and part IV.D., below.

c. Other Rules

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

d. Deemed Distribution of Acquiror's Installment Note

The Current 338 Regulations treat the installment obligation as distributed to Seller. If there is more than one Old T shareholder, the installment obligations are treated as distributed to the shareholders in the same amount they actually receive in the stock sale. Reg. § 1.338(h)(10)-1(d)(8)(ii).

e. Possible Immediate Gain Recognition

The most important part of the Current 338 Regulations relating to the installment method is an example dealing with an S corporation. Reg. § 1.338(h)(10)-1(e) *Example 10* shows that, if some Target shareholders receive cash and others receive installment notes, there is some immediate gain recognition in the deemed asset sale, but installment sale treatment remains in effect notwithstanding the deemed liquidation of Old T. The most important point illustrated by the example is that, even if a particular Target shareholder receives only installment notes, he or she may recognize immediate gain if other shareholders receive cash or do not sell their stock.

f. Treatment of Contingent Purchase Price and Contingent Liabilities

Neither the rules nor the example deals explicitly with contingent purchase price or contingent liabilities under the installment method. In an actual asset sale under the installment method, Target would recognize gain as the contingent payments are received. *See* part I.C.4., above. If Target is an S corporation, this gain would be passed through to the shareholders and would cause adjustments in the basis of the Target stock and in the gain recognized to the shareholders in the deemed liquidation.

2. Election Out of Installment Method

As in an actual asset sale, the installment method automatically applies unless Old T is ineligible for the installment method or elects out. 64 Fed. Reg. 43,462 at 43,471 (Aug. 10, 1999); *see* parts I.C.2. and I.E.2., above. Because of the possibility that any sale with a contingent liability could be eligible for the installment method (*see* part I.C.1., above), and because the installment method would delay full basis recovery, an election out should be made if Seller does not wish to use the installment method.

a. Amount Realized at Closing and Gain or Loss Recognized – Closed Transaction Method

If Old T elects out of the installment method, Old T reports as amount realized at closing the fair market value of the contingent purchase price (as in an actual asset sale). Reg. §§ 1.1001-1(g)(2)(ii), 15a.453-1(d)(2)(iii). *See* part I.B.1.a., above. Although the Current 338 Regulations do not explicitly so state, the preamble to the proposed regulations describes this change in the regulations as "breaking the link" between deemed seller (Old T) treatment (ADSP) and deemed acquiror (New T) treatment (AGUB). 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). *See* part II.C.4., below. In this case, Old T should be able to recover its full asset basis against the amount realized at closing and report either gain or loss based on normal closed transaction principles. The issue remains, however, whether Old T must determine the fair market value of New T's deemed assumption of Old T's contingent liabilities, and treat this value as amount realized at closing, or whether it is taken into account later. *See* parts II.B.2.d. and IV.D., below.

b. Amount Realized Upon Receipt of Contingent Purchase Price

A contingent purchase price obligation deemed paid to Old T by New T is separate property with a basis in the hands of Old T (or its shareholders after the deemed liquidation). *See* part I.B.2.e. through part I.B.2.g., above.

- One way to analyze this situation is that, when the contingent purchase price is accrued or paid, principal amounts, discounted from the date of sale, are treated as proceeds from the payments on this obligation. Once the basis in the obligation has been recovered, Old T recognizes gain or loss. This gain or loss may be either capital gain or loss or ordinary income or loss. *See* parts I.B.2.e. through I.B.2.g., above. The balance of the payments is interest income to Old T at the AFR or at a higher agreed-upon rate.
- The alternative analysis is to treat the contingent purchase price as an adjustment to the amounts received in the deemed asset sale (ADSP), with gain or loss on the deemed asset sale being adjusted for the difference between the fair market value of the contingent payment obligation and the amount received (adjusted for time value). Under this analysis, contingent purchase price would relate back to the day after the acquisition date, for both ADSP and AGUB purposes. Reg. §§ 1.338-4(b)(2)(ii), 1.338-5(b)(2)(ii). This analysis is like the open transaction method.
- The Current 338 Regulations do not state which analysis applies. The preamble to the proposed regulations states that "general principles of tax law" apply in connection with contingent items. Thus, the Current 338 Regulations treat section 338(h)(10) stock sales like actual asset sales and eliminate the special "fixed and determinable" rule in the Old 338 Regulations (Old Reg. § 1.338(b)-3T(c)). 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). Thus, the general "closed transaction" rule for asset sales applies here as well.

c. Amount Realized at Closing – Open Transaction Method

In the "rare and extraordinary cases" where the contingent purchase price cannot be valued, Old T may use the open transaction method and so have amounts realized only upon receipt or accrual and recover its full basis in the assets up front, as payments are received or accrued, subject to interest imputation. *See* parts I.B.1.b. and I.B.3., above.

d. Amount Realized Upon Fixing or Payment of Target's Contingent Liabilities

Contingent liabilities deemed assumed by New T are taken into account by New T when the liabilities become fixed (accrual method) or are paid (cash method). There is no imputed interest or original issue discount. *See* part IV.D.1.a.(2), below. Payment of the liability may also result in an offsetting deduction to Old T. *See* parts II.B.4.c. and IV.D.2.a., below. No authority states whether assumption of contingent liabilities in an asset purchase must be valued and taxed to Seller as amount realized at closing, like contingent purchase price. Reg. § 1.1001-1(g)(2)(ii) includes contingent "debt instruments" in amount realized, but it is not clear whether this term includes assumption of contingent liabilities. Reg. § 1.1001-2(a)(3) provides that an assumption of a liability is not included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis for such property." But this exclusion applies only to "a liability incurred by reason of the acquisition of the property" – presumably an earlier "acquisition of the property" by the Seller. Still, this provision could be read to suggest a deferral for assumption of contingent liabilities not yet taken into account at the time of closing. *Cf.* Code sections 357(c)(3), 358(d) discussed in part X.A., below. In *Crane v. Commissioner*, 731 U.S. 1

(1937), the Supreme Court held that the amount realized on a sale of property includes the principal balance of a mortgage to which the property is subject, but the Court agreed with the Commissioner that accrued but unpaid interest was not included (Seller was on the cash method), because the interest would be deducted when paid. Does this conclusion mean that an assumption of a contingent liability is not included in amount realized because it will be deductible when paid? Probably not. The Commissioner probably excluded the interest, because the deduction would offset the amount realized. In addition, the rule that there is no imputed interest or original issue discount implies that no valuing and current tax is required. This seems to be the better answer. If contingent liabilities need not be valued at closing, then, even in an otherwise closed transaction (*see* part II.B.2.b., above), the accrual or payment of contingent liabilities will result in ADSP adjustments (*see* parts II.B.2.b., above, and IV.D., below).

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

(1) Background

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

(2) Taxation

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

(3) Treatment of Tax Liability

Unlike the Old 338 Regulations (which assume that Old T's shareholders will pay this tax), the Current 338 Regulations, in effect, require the parties to allocate tax liability resulting from the deemed asset sale between themselves. The general rule is that, for purposes of determining amount realized to Old T on the deemed asset sale and New T's asset basis, the tax liability on the deemed asset sale is like any other liability:

> Commentators asked for further clarification of the standards for taking certain taxes into account. Rather than providing more specific guidance, which would be inconsistent with the overall philosophy of deferring to general tax principles governing actual transactions, the final regulations further simplify the discussion of liabilities. Except for the fact that new target remains liable for old target's tax

> liabilities (see section 1.338-1(b)(3)(i)) and that a buyer's assumption of a seller's income tax liability with respect to the sale causes the consideration to "gross up" or "pyramid," a tax liability is like any other type of liability and the status of any particular type of tax liability as a liability includible in ADSP or AGUB should be determined under general principles as applied to the facts relating to the incidence of the tax liability.

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

3. Allocation of Amounts Realized Among Assets Deemed Sold

Old T's amount realized is the fixed portion of the purchase price, plus the fair market value of the contingent purchase price, allocated among all assets, tangible and intangible, under section 1060. The amount realized is considered paid first for cash and cash equivalents (Class I), then actively-traded personal property (including certificates of deposit and foreign currency) (Class II), then accounts receivable, mortgages and credit card receivables which arise in the ordinary course of business (Class III), then inventories (Class IV), then all other non-assigned assets (Class V), then intangibles other than goodwill (Class VI) and finally goodwill (Class VII). Reg. §§ 1.338-6(b), 1.1060-1(c)(2). Later adjustments in the purchase price would result in readjustments to this allocation. Reg. §§ 1.338-4(b)(2)(ii); 1.338-7(b).

4. Character of Amounts Realized

a. Contingent Purchase Price

A contingent purchase price obligation is treated as a separate contingent obligation owed by New T to Old T. Old T determines the amount and timing of interest under the contingent debt obligation rules, discounting back to the date of sale. Reg. § 1.1275-4(c). This determination is made when the principal component is includible in Old T's amount realized, *i.e.*, in the year the amount is paid or the contingency becomes fixed, and the balance of the payment is interest. It is not clear whether the principal payments result in ordinary income (or loss) or capital gain (or loss). *See* parts I.B.2.e. through g., above.

b. Contingent Liabilities – Gain

The Current 338 Regulations avoid any specific rule for contingent liabilities but rather state that contingent liabilities are taken into account as though there had been an actual asset sale. Reg. §§ 1.338-4(d)(2) (ADSP); 1.338-5(e)(2) (AGUB). Under these principles, there is no imputed interest on these amounts. *See* parts II.B.2.d., above, and IV.D.1.a.(2), below.

c. Contingent Liabilities – Deductions

The 1999 proposed regulations introduced a new all-purpose term – "deemed sale gain" – to include all of Old T's tax consequences from a deemed asset sale. The preamble commented on this term as follows:

> The expanded definition of deemed sale gain, in conjunction with the rules in § 1.338-7(c) of the proposed regulations (§ 1.338(b)-3T(h) of the current regulations), provides a mechanism for [Old T] . . . to report items that are

> properly taken into account after the acquisition date. One such item would be the deduction of an assumed liability of [Old T] that it could not deduct under its method of accounting on or before the acquisition date.

64 Fed. Reg. 43,462 at 43,467 (Aug. 10, 1999). This passage confirmed the general treatment of offsetting amount realized and deduction when an otherwise-deductible or capitalized contingent liability becomes fixed or is paid. The Current 338 Regulations substituted the more descriptive term, "deemed sale tax consequences" for the same concept.

C. Treatment of New T

From New T's perspective, a deemed asset purchase involving contingent consideration (whether contingent purchase price or Old T's contingent liabilities) is accorded open transaction treatment, as in an actual asset purchase. *See* part I.D., above. That is, New T gets no asset basis for the contingent purchase price or contingent liabilities until the amounts are accrued or paid. The Current 338 Regulations did not change this treatment. It is clear, however, that the section 461(h) economic performance rules that would delay inclusion of these amounts in New T's asset basis do apply. 64 Fed. Reg. 43,462 at 43,465 (Aug. 10, 1999).

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

The same rules apply to section 338(h)(10) stock acquisitions as to actual asset acquisitions. *See* part I.D.1., above, and, for discussion of the new asset classes, *see* parts II.B.3., above, and II.C.3., below.

2. Timing of Effects on Basis

The same rules apply to section 338(h)(10) stock sales as to actual asset acquisitions. *See* part I.D.3., above.

a. Upward Basis Adjustments

Upon making an additional purchase price payment to Old T or accruing or paying a contingent liability, New T is entitled to make an upward basis adjustment. Reg. §§ 1.338-7(b), (d); Reg. § 1.197-2(f)(2)(i).

b. Recovery Methods and Periods

New T allocates each payment among the purchased assets in the order described in Reg. § 1.338-6(b). *See* part II.B.3., above, and part II.C.3., below. New T adjusts basis in depreciable property and takes depreciation deductions proportionately over the remaining life of the assets. If the asset has been disposed of or fully depreciated at the time the adjustment is made, the Current 338 Regulations refer to general principles of tax law. Reg. §§ 1.338-7(c)(3). Presumably, under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952), New T recognizes loss in this situation.

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

The regulations under section 197 eliminate the argument that amounts paid for the use of intangibles can be deducted instead of amortized. Reg. §§ 1.197-2(a)(3), (b)(11), (f)(3)(ii) and (g)(6). *See* part I.D.4., above. But there are exceptions, including the following:

(1) No Acquisition of a Trade or Business

Payments for a right to use intangibles which are not part of an acquisition of a trade or business fall outside of section 197 amortization. Reg. §§ 1.197-2(f)(3)(ii)(A), (f)(3)(iii). The basis of a right to a fixed amount is amortized for each taxable year by multiplying the basis by a fraction, the numerator of which is the amount received during the taxable year and the denominator of which is the total amount to be received under the contract. Reg. § 1.167(a)-14(c)(2)(ii). If the right to use an intangible is of an unspecified amount but of a fixed duration shorter than 15 years (including all reasonably expected renewals), then the payment is amortized ratably over that duration. Reg. § 1.167(a)-14(c)(2)(ii). Payments which are part of an acquisition of a trade or business, on the other hand, are subject to section 197. Reg. § 1.197-2(k) *Example 5*. (*See also* Reg. § 1.197-2(c)(7), providing that interests in patents and copyrights not acquired as part of an acquisition of a trade or business are not section 197 intangibles, and Reg. § 1.167-14(c)(4), providing rules for amortizing payments for such interests.)

(2) Exception to Acquisition of Trade or Business

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

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

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

(4) Exception for Information Base

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

(5) Timing of Amortization; Deductions for Imputed Interest

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

d. Elimination of Special Purchase Price Allocation

As a simplification measure, the Current 338 Regulations eliminate the rule allowing contingent payments to be allocated to specific intangible assets. Old Reg. § 1.338(b)-3T(g). IRS requested comments on this point when this change was proposed. Preamble to Proposed Regulations at 43470. But the change was adopted in the Current 338 Regulations. *See* part I.D.2., above.

3. Elimination of Phantom Income

An important Acquiror-side change in the Current 338 Regulations is the addition of separate asset classes for receivables (new Class III) and inventories (new Class IV). Adding these two new asset classes ahead of the "everything else" class (old Class III, new Class V) means that, in a bargain purchase, receivables and inventories are more likely to attract basis equal to their full fair market value and not share basis with other assets. This change prevents phantom income from being taxed when purchased receivables are collected or inventories sold. 64 Fed. Reg. 43,462 at 43,469 (Aug. 10, 1999). Although this change is not specifically related to contingent purchase price or contingent liabilities, it is especially apt to become relevant in situations where Acquiror assumes large contingent liabilities, or where indemnity payments by Seller to Acquiror reduce the purchase price. Some practitioners have expressed concern that the new asset classes are too narrow, and that the descriptions of these new classes are not clear enough. Note that the phantom income problem can still exist in section 338(h)(10) acquisitions of tiered target corporations because the stock of a subsidiary is a class V asset, even if section 338(h)(10) elections are made for both parent and subsidiary. (This mechanism is referred to as "top down.") 64 Fed. Reg. 43,462 at 43,473-74 (Aug. 10, 1999).

4. "Breaking the Link" Between ADSP and AGUB

The Current 338 Regulations confine open transaction treatment for Old T to "rare and extraordinary" cases (*see* part II.B.2.c., above). On the New T side, however, the Current 338 Regulations continue to require open transaction treatment. In most situations involving contingent purchase price, the results will be completely inconsistent treatment as between Old T and New T.

a. Old T's Treatment

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

b. New T's Treatment

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

c. The Inconsistency

This inconsistency of treatment between Seller and Acquiror is intentional, in the sense that IRS and Treasury determined that section 338(h)(10) stock sales should be treated under existing law governing asset sales. 64 Fed. Reg. 43,462 at 43,468 (Aug. 10, 1999). Taxpayers may be expected to engage in self-help to avoid this whipsaw. Steps may include (i) claiming open transaction treatment because the contingent purchase price obligation cannot be valued, (ii) claiming closed transaction treatment but claiming a low fair market value for the contingent purchase price obligation, (iii) using escrows in lieu of contingent purchase price obligations (*see* part III., below), and (iv) casting contingent purchase price obligations as contingent liabilities of Target, which may escape immediate redemption for Seller (*see* part II.B.2.d., above).

D. Reporting and Administrative Requirements

1. Forms 8023 and 8883

a. Revised Form 8023

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

b. Form 8883

In contrast to an actual sale of assets, no Form 8594 need be filed in a stock sale with a section 338(g) or section 338(h)(10) election. The preamble to the Current 338 Regulations stated that, in revising Forms 8023 and 8594, IRS and Treasury were considering requiring Acquiror and Seller to report their respective allocations on separate copies of Form 8594. 66 Fed. Reg. 9,925 at 9,928 (Feb. 13, 2001). Instead, however, IRS developed a separate form for this purpose. Form 8883, *Asset Allocation Statement Under Section 338* (Rev. Oct. 2002). In a section 338(h)(10) situation, this form is filed with the returns of Old T and New T. Separate forms are filed, and they need not be conformed. The instructions state that this form allows the parties to make a section 338(h)(10) election on a timely basis, even if the allocation of purchase price among the assets has not yet been determined. As in a section 1060 asset purchase (*see* part I.E.1., above), the parties may not be able to file agreeing Forms 8883, because of differing tax treatment of contingent purchase price and assumption of contingent liabilities, and because of their respective transaction costs. The new form provides for changes in allocation. Supplemental statements must be filed if the allocations change.

2. Other Administrative Requirements

Generally, for purposes other than computing "deemed sale tax consequences" by Old T (*see* part II.B.4.c., above), and asset basis and depreciation by New T, Old T and New T are treated as the same corporation. Examples include treatment under various employee benefit and employment tax rules, continuation of the same employer identification number and, most important, New T's continuing liability for Old T's taxes (including several liability for all income tax owed by a Seller consolidated group under Reg. § 1.1502-6). Reg. §§ 1.338-1(b)(2), (b)(3) and 1.338(h)(10)-1(d)(2).

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

Note: This part discusses the rule that applied to transactions that took place prior to the adoption of the Temporary Regulations in January 2000. Transactions after January 5, 2000, are subject to temporary regulations. *See* part II.A., above. Transactions after March 16, 2001, are subject to the Current 338 Regulations, discussed in part II., above, generally.

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

Sellers seeking open transaction treatment under the Old 338 Regulations might have been tempted to restructure an asset sale by dropping the assets into a newly-created subsidiary and selling the subsidiary's stock under a section 338(h)(10) election. Using a newly-created subsidiary in a section 338(h)(10) transaction, however, was problematic. For the asset drop to be tax free under section 351, sellers had to retain "control" of Target "immediately after the exchange" by not, for example, entering into a binding commitment or other prearranged integrated plan to sell the Target stock to Acquiror at the time the assets are transferred. Rev. Rul. 70-140, 1970-1 C.B. 73 (agreement to sell stock in place when assets transferred to subsidiary; *held*, prearranged integrated plan, seller lacked "control").

A. Treatment of Old T

1. Installment Method Not Available

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

2. Amount Realized at Closing

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

3. Amount Realized Upon Receipt

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

4. Allocation of Amounts Realized Among Assets Deemed Sold

Old T's amount realized was the fixed portion of the purchase price, allocated among all assets, tangible and intangible, under section 1060, under the five-class system then in effect. The amount realized was considered paid first for cash and cash equivalents (Class I), then short-term securities (Class II), all other non-assigned assets (Class III), intangibles other than goodwill (Class IV), and finally goodwill (Class V). Old Reg. §§ 1.338(b)-2T(b), 1.1060-1T(d). These were the only asset classes under the Old 338 Regulations.

5. Post-Closing Adjustments

The Old 338 Regulations provided for adjustments to ADSP and AGUB and adjustments to the allocation of purchase price among asset classes for specified events. There were two separate but similar regimes – one for events (referred to as "adjustment events") occurring after closing but before the end of New T's first taxable year and the other for events occurring later. The events that triggered adjustments were changes in the status of liabilities from contingent to fixed, reductions in amounts paid by Purchaser to Seller (*e.g.*, returns of purchase price) and reductions in the amount of Old T liabilities. If the adjustment event occurred before the end of New T's first taxable year, the adjustment was effective as of the beginning of the day after closing. Otherwise, the adjustment was effective when the event occurred, "under general principles of tax law." Old Reg. §§ 1.338(b)-1(b), 1-338(b)-1(c)(2), 1.338(b)-3T(a)(1), 1.338(b)-3T(f)(2). Note that there was no provision to adjust allocation of purchase price to take into account information regarding the fair market value of assets purchased coming to Purchaser's or Seller's attention after the closing.

6. Recovery of Asset Basis

Old T could recover up-front its basis in the assets as of the date of the deemed sale of assets. I.R.C. § 338(h)(10)(A). Old T still could not recognize a loss on the sale, however, until the contingent payments were received or fixed.

7. Character of Amounts Realized – Actual and Imputed Interest

A right to contingent purchase price payments was treated as a separate contingent debt obligation from New T to Old T. Under the open transaction method, Old T still determined the amount and timing of interest under the contingent debt obligation rules, discounting back to the date of sale. Reg. § 1.1275-4(c). However, this determination was made when the payment was received or fixed, and the principal component was fully includible in Old T's amount realized in the year the amount was paid or the contingency became fixed, and the balance was interest. (Because Old T was deemed to have liquidated, these amounts were taxed to Seller, Old T's shareholder.)

B. Treatment of New T

From New T's perspective, a deemed asset purchase involving a contingent purchase price had open transaction treatment, as in an actual asset sale described in part I.D., above. New T generally received no basis for the contingent payments until they were paid. This basic rule has not changed under the Current 338 Regulations.

1. Allocation of Contingent Purchase Price Among Assets Purchased

The same rule applied to section 338(h)(10) stock sales as to actual asset sales. *See* parts I.D.1. and I.D.2., above. But, under the Old 338 Regulations there were only five asset classes. *See* part II*.A.4., above.

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

The same rule applied to section 338(h)(10) stock sales as to actual asset sales. *See* part I.D.3., above.

a. Upward Basis Adjustments.

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

b. Recovery Methods and Periods – Tangible Assets.

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

III. Escrows and Other Returns of Purchase Price

An escrow may be used to secure contingent purchase price payments or Seller's indemnity to Acquiror for breach of Seller's covenants, representations or warranties, or for undisclosed liabilities. The tax issues raised by these escrows include the following: Are the amounts placed in escrow treated as part of the purchase price at closing (in whole or in part)? To whom is the income on the escrowed funds taxed, as earned and as distributed? How are adjustments made once the recipient of the escrowed funds is determined and the amounts are paid?

Proposed regulations under section 468B(g), published in January 1999, would determine how the income on escrowed funds is taxed but not the other issues, which are left to case law. Thus, if the proposed regulations were adopted, there would be significant inconsistencies in the treatment of the escrows.

A. Whose Property Is the Escrow?

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

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

a. Seller's Liability

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

b. Breaches and Undisclosed Liabilities

Many escrows protect Acquiror against undisclosed or unascertainable liabilities of the ongoing business or breaches by Seller of covenants, warranties or representations in the sale agreement.

IRS takes the view that Seller is deemed to receive the escrowed funds unless its rights to the funds are subject to substantial restrictions. Rev. Rul. 79-91, 1979-1 C.B. 179; Rev. Rul. 77-294, 1977-2 C.B. 1973; PLR 200521007 (Feb. 25, 2005). The case law is not so clear. *See Anderson v. Commissioner*, 20 T.C.M. 697 (1961) (Seller recognizes no income when Acquiror places funds in escrow against possible breach of warranty as to undisclosed corporate liabilities). The parties should reach agreement on this point, document it and report consistently, so that the agreed-upon party indemnifies the other for the tax if IRS disagrees.

2. Income on Escrowed Funds

Rev. Rul. 71-119, 1971-1 C.B. 163, *revoked*, Rev. Rul. 92-51, 1992-2 C.B. 102, created the possibility of "homeless" income on escrows, *i.e.*, income on which no one pays tax as long as the escrow lasts. After enactment of section 468B(g) in 1986, however, escrows could no longer generate homeless income. Section 468B(g) states:

> Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

Implementing regulations could deal with this situation in several ways. Seller could be the grantor of a grantor trust (escrow funds treated as though paid to Seller and then placed in escrow), or Acquiror could be the grantor (escrow funds treated as contingent purchase price not yet paid, as discussed in part I., above). Or, the escrow could be a separate taxpayer. In the absence of regulations under section 468B(g), Acquirors and Sellers may structure escrow arrangements by choosing which is treated as the grantor. In January 1999, regulations were proposed to require that, for purposes of taxing escrow income, escrowed purchase price is treated as continuing to belong to Acquiror (the provider of the cash) until the rights to the funds are fully established. Prop. Reg. § 1.468B-8 (Jan. 29, 1999). *See* part III.B.3., below.

B. If Escrow Is Acquiror's Property

1. Escrow as Acquiror's Property – Treatment at Closing to Seller

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

2. Escrow as Acquiror's Property – Treatment at Closing to Acquiror

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

3. Escrow as Acquiror's Property – Income Earned on Escrowed Funds – Prop. Reg. § 1.468B-8

a. "Contingent At-Closing Escrow" Defined

Under proposed regulations published in 1999, a "contingent at-closing escrow" is an escrow or similar fund established at the closing of a sale or exchange of trade or business or investment property, but not a tax-free reorganization (*see* part VII., below) or a deferred section 1031 exchange. REG-209619-03, 1999-1 C.B. 689. Section 351 exchanges and section 355 corporate separations are not mentioned. The escrow awaits resolution of contingencies that will determine whether Acquiror or Seller is entitled to the escrowed funds. Until all issues that could determine receipt of the escrow are resolved, the income on the escrow continues to be taxed to Acquiror, even if it has been resolved that some of the escrowed funds will be distributed to Seller. To fine tune the application of this rule, consider a separate escrow fund for each contingency, so that each determination can affect an entire separate fund.

b. Scope of Proposed Regulations

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

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

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

d. Status of the Proposed Regulations

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

4. Disputed Ownership Funds

The proposed regulations contained separate rules for "disputed ownership funds," which are escrows and similar funds under court jurisdiction pending resolution of a dispute. Prop. Reg. § 1.468B-9. The proposed regulations were adopted as final regulations with minor changes in

2006. T.D. 9249, 71 Fed. Reg. 6197 (Feb. 7, 2006). The income of such a fund is taxed to the fund as a separate entity, generally a "qualified settlement fund" ("QSF"), under Reg. § 1.468B-1. The regulations also allow the grantor of a QSF to elect to have the income earned by the QSF taxed to the grantor instead of to the QSF as a separate entity. Thus, if Acquiror so elects, Acquiror will continue to be taxed on escrow income. The preamble to the proposed regulations requests comments as to transitions of funds from contingent at-closing escrow to "disputed ownership fund" status. *See* Rev. Rul. 87-127, 1987-2, C.B. 156 (income earned on amounts placed in pre-need funeral trust generally taxed to customer; *but see* section 685 of the Code).

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

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

6. Escrow as Acquiror's Property – Treatment on Return of Escrowed Funds to Acquiror

The return of escrowed funds to Acquiror is not treated as a reduction in the purchase price, because amounts were never considered to have been paid to Seller. Return of funds would be no more than a return to Acquiror of its own funds.

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

An escrow is commonly used to fund contingent or other undisclosed liabilities. If these liabilities become fixed, and escrowed funds are used to pay them, the amounts paid should be treated like the payment of an unfunded contingent liability.

a. Treatment to Seller

The amount paid should be added to Seller's amount realized on the sale (except to the extent already included at closing – *see* part III.B.1., above). Seller should be entitled to an offsetting deduction for the amount paid, if the liability is a deductible item. *See* parts IV.D.2.a. and IV.D.3., below.

b. Treatment to Acquiror

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

C. If Escrow Is Seller's Property

1. Escrow as Seller's Property – Treatment at Closing to Seller

If the escrowed funds are treated as having been paid to Seller, the tax consequences at closing do not depend on the contingent purchase price rules. Rather, the section 1001(b) rules apply, because the escrowed funds would be considered part of the sale proceeds. *See* parts I.B.1.a. and II.B.2.a. and b., above. That is, the full amount of the escrowed funds is added to Seller's amount realized. There is no imputed interest because the amount is treated as paid to Seller at the time of sale and transferred by Seller into the escrow. Seller could not treat the escrow as an installment sale.

2. Escrow as Seller's Property – Treatment of Escrow at Closing to Acquiror

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

3. Escrow as Seller's Property – Income Earned on Escrowed Funds

a. Investment Treatment

Under Prop. Reg. § 1.468B-8(c), discussed in part III.B.3., above, even if the escrow is Seller's property for tax purposes generally, the income earned on the escrowed funds still would be taxable to Acquiror until the "determination date." Thus, Seller could be taxed in full on the escrowed funds at closing, while Acquiror is taxed on the income from those funds – clearly inconsistent treatment. This inconsistency would have to be reconciled with economic reality, if the escrowed funds are ultimately paid to Seller.

b. Example

Suppose an escrow of part of the purchase price paid for a business is treated as belonging to Seller at closing (*e.g.*, an escrow to secure Seller's indemnity obligation or Acquiror's contingent purchase price obligation). That is, at closing the funds in escrow are included in Seller's amount realized on the sale. The amount realized by Seller and Acquiror's asset basis are computed without regard to the proposed regulations. Suppose further that the income on the escrowed funds is distributed to Seller periodically as earned. Still, under § 1.468B-8, the income will be taxed to Acquiror. Does the distribution of the income to Seller count as additional purchase price, taxed again to Seller? Or, does the limited scope provision in Prop. Reg. § 1.468B-8(d) mean that this income and its distribution are simply ignored for purposes of amount realized and basis? If so, Acquiror will be taxed on income it never receives, and Seller will receive cash on which it never will be taxed. In light of this problem, Treasury and IRS should reconsider their approach to this income.

c. Avoiding the Problem

To avoid this complication, Acquiror and Seller should make efforts to avoid escrows of funds that belong to Seller for other purposes. Or the parties should agree that the escrow funds belong to Acquiror until the determination date under the proposed regulations. Nevertheless, Seller probably would have to treat its contingent right to receive the escrowed funds as amount realized at closing, under the "closed transaction" method. *See* part I.B., above.

4. Escrow as Seller's Property – Treatment on Payment to Seller

There are no consequences to a distribution of escrowed funds to Seller. The escrowed amount would have been added to Seller's sales proceeds at the date of the sale, except that earnings for the taxable year in which the escrow is resolved would be currently includible in Seller's income.

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

a. Treatment to Seller

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

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

(2) Escrow Secures a Deductible Obligation

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

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

If Seller has treated the escrowed funds as contingent purchase price and so included the fair market value of the contingent payment right in amount realized at closing, the return of the escrowed funds to Acquiror would result in a loss to Seller on the separate contingent payment right. *See* part I.B.2., above.

b. Treatment to Acquiror

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

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

a. Treatment of Seller

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

b. Treatment of Acquiror

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

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

1. Escrowed Stock – Taxable Gain to Acquiror

a. Stock of Acquiror

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

b. Stock of Acquiror's Parent

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

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

More recent regulations adopt a similar approach without regard to whether parent and Acquiror file consolidated returns (and even without regard to whether parent and Acquiror are affiliated). Under these regulations, Acquiror would recognize no taxable gain or loss, provided it transfers the stock "immediately." Reg. § 1.1032-3(c)(2). Based on examples in these regulations, "immediately" seems to mean that, in an escrow situation, Acquiror may not be entitled to any reversionary interest in the parent stock. Thus, escrow agreements involving parent stock should provide that any reversion of the parent stock is to parent, not to Acquiror. In any event, if parent and Acquiror file a consolidated return, Acquiror would recognize no loss on its disposition of parent stock. Reg. § 1.1502-13(f)(6)(i).

2. Escrowed Stock – Tax on Dividends

a. Stock of Acquiror

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

b. Stock of Acquiror's Parent

Suppose Acquiror is a subsidiary, and stock of Acquiror's parent is placed into an escrow. In this case, the dividend income presumably would be taxed to the subsidiary subject to the dividends received deduction – probably100% under section 243(b).

IV. Contingent Liabilities in Taxable Asset Acquisitions

A. Introduction

In asset acquisitions Acquiror may assume Target obligations that are not fixed in amount or timing, or both. These types of contingent obligations include retirement, vacation and severance pay and other employee benefits, environmental remediation costs, commercial and tort claims, tax deficiencies, etc. The tax consequences depend upon whether the particular item is treated as an assumed liability (capitalized as part of the purchase price) or as Acquiror's own expenditure (possibly deductible). Generally, the tax consequences affect Acquiror more than Seller or Target.

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

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

a. Target's Liabilities Assumed

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

b. Acquiror's Costs

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

c. Incentives to Seller, Target and Acquiror

It is generally advantageous to all parties to treat an expenditure by Acquiror as Acquiror's cost of doing business, rather than as an assumption and payment by Acquiror of Target's liability. This is especially true if the expenditure would result in an immediate deduction upon payment, as is most common. Thus, it can be expected that the parties will try to use this treatment whenever possible.

d. Capitalization or Deduction by Acquiror

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

2. Authorities

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

a. Pre-Sale Operations

Does the expenditure arise from Target's pre-sale operations or from post-acquisition events?

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

- *Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981) (*acq*.). Cash basis Target treated as paying accounts payable assumed by Acquiror, because Acquiror assumed liabilities instead of paying more cash; Acquiror's basis in assets increases by amount of payable.

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

- *Illinois Tool Works, Inc. v. Commissioner,* 117 T.C. 4 (2001), *aff'd* 355 F.3d 997 (7th Cir. 2004). Buyer's payment of $15 million judgment in patent infringement case capitalized where liability was assumed from seller of business, even though adverse judgment was a surprise; court rejected theory based on taxpayer's failure to settle case at less than $1 million. *See* P. Cook & M. Speery, "Contingent Liabilities after *Illinois Tool Works, Inc.*, 2 Mergers & Acquisitions 12-20 (Nov. 2001); B. Raby & W. Raby, "Contingent Liability Payments in Business Purchases," 92 Tax Notes 941 (Aug. 13, 2001).

b. Timing of Liability

Did legal liability for the item arise before or after the acquisition? If legal liability had arisen before the acquisition, was there substantial benefit to Acquiror in making the expenditure (other than the satisfaction of its liability)?

- *Magruder v. Supplee*, 316 U.S. 394 (1942). Assumed liability for real estate tax on purchased property added to basis (law changed by section 164(d)).
- *H. Hamburger Co. v. Commissioner*, 8 T.C.M. (CCH) 780 (1949). Payment of predecessor's debt to improve successor's credit rating deductible to successor.
- *Rees Blow Pipe Manufacturing Co. v. Commissioner*, 41 T.C. 598 (1964) (nonacq.), *aff'd per curiam*, 342 F.2d 990 (9th Cir. 1965). Target paid damages for concealing defects in property it transferred in like-kind exchange; payment treated as capital loss under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); corollary would be reduction to Acquiror's purchase price.
- *Hyde v. Commissioner*, 64 T.C. 300 (1978). Acquiror purchased property in foreclosure subject to mortgage, then redeemed the property by paying the debt; taxes and interest accruing after purchase deductible; pre-purchase taxes and interest capitalized; redemption fee deductible as interest. *See also* TAM 200048006 (Aug. 14, 2000).
- *Gibson Products Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981). Obligation on nonrecourse note issued to oil well driller contingent on production *held* loan under "all events" test and payment was payment of loan, not deductible intangible drilling cost.

c. Surprise

Was Acquiror aware of the liability, or was it a surprise? Was the item reflected in the relevant financial statements, *e.g.*, as a reserve? Was it explicitly reflected in the purchase price? Was it explicitly assumed in the acquisition documents?

- *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d Cir. 1952). Acquiror assumed obligation of lessee on lease, but lessee compensated Acquiror by transferring a building to it; even though Acquiror reported value of building as income when received, Acquiror's depreciable cost basis in building *held* limited to allocable portion of contingent liability assumed – zero because of favorable lease terms.
- *Pacific Transport Co. v. Commissioner*. *See* part IV.B.2.a., above.
- *Illinois Tool Works, Inc. v. Commissioner*. *See* part IV.B.2.a., above.
- P. Canellos, *Reasonable Expectations and the Taxation of Contingencies*, 50 Tax Law. 299 (1997).

d. Litigation Costs

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

3. Authorities on Employee and Retiree Compensation and Benefits

A number of authorities deal with compensation issues, such as pensions, vacation pay, settlement of employee stock options, retroactive wage increases. Regulations provide a "simplifying convention" relating to costs that "facilitate" an acquisition. Normally, these costs must be capitalized in the acquired assets. Under the regulations, however, compensation paid to employees (including bonuses and commissions) need not be capitalized even if the employees are compensated for work that facilitates an acquisition of an intangible. Reg. §§ 1.263(a)-4(e)(4)(ii), 1.263(a)-4(e)(5) *Example (8)*. The same rule applies for compensation paid to employees to facilitate an acquisition of a trade or business. Reg. §§ 1.263(a)-5(d). Under recent proposed regulations, the same rule also would apply to employee compensation and overhead to acquire tangible property. Prop. Reg. § 1.263(a)-2(d)(3)(ii)(D). This rule seems to allow Acquiror to deduct a wider range of employee compensation and benefits, to the extent attributable to services that are related to the acquisition itself. It does not affect the treatment of employee compensation or benefits for other services rendered to Target.

a. Pensions – Retired Employees

Pensions paid by Acquiror for already-retired employees are treated as liabilities assumed from Target. *F. & D. Rentals v. Commissioner*, 365 F.2d 311 (7th Cir. 1966), *aff'g* 74 T.C. 335 (1965), *cert. denied*, 385 U.S. 1004 (1967); *David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981); *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44.

b. Pensions – Employees Not Yet Retired

Pensions paid by Acquiror for employees not yet retired at the time of the acquisition are Acquiror's costs, deductible by Acquiror as incurred. *M. Buten & Sons v. Commissioner*, cited in part IV.B.3.a., above.

c. Qualified Retirement Plan Contributions

Contributions to continue a qualified retirement plan (including meeting minimum funding standards and to funded plan liabilities unfounded by Target) are also Acquiror's costs and so are deductible. GCM 39274 (Aug. 16, 1984). *See also* PLR 7816063 (Jan. 23, 1978); PLR 8152055 (Sept. 29, 1981); PLR 8202115 (Oct. 16, 1981); PLR 8205022 (Nov. 3, 1981); PLR 8411106 (Dec. 16, 1983); TAM 8436002 (Mar. 23, 1984); 1994 FSA LEXIS 490 (May 9, 1994).

d. Retiree Medical Expense

Often retiree medical plans are revocable at any time. If so, should the payments be treated as deductible Acquiror's costs, because Acquiror makes the payments to improve worker morale and preserve the business? The treatment of pension plan expenses in GCM 39274 (cited in part IV.B.3.c., above) would support this idea. *See also H. Hamburger Co. v. Commissioner*, discussed in part IV.B.2.b., above. *But see* FSA 1999-1068 (Oct. 8, 1993) (payment of assumed retiree health and life insurance benefits capitalized).

e. Retroactive Pay Increase

Retroactive pay increases are Acquiror's costs if Acquiror finally agreed to them after the acquisition. *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831 (1963); *United States v. Minneapolis & St. Louis Railway Co.*, 260 F.2d 663 (8th Cir. 1958).

f. Target Employee Stock Options, SARs and Severance Pay

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

- Rev. Rul 73-146, 1973-1 C.B. 61. Target deducts amounts paid by it to employees to terminate nonqualified stock options in connection with tax-free type-B reorganization. *See* J. S. Starkey, "Tax Treatment of Employee Stock Options in Mergers and Acquisitions," 90 Tax Notes 1231 (Feb. 26, 2001). For further discussion of contingent liabilities in tax-free reorganizations, *see* part X., below.

- *Great Lakes Pipe Line Co. v. United States*, 352 F. Supp. 1159 (W. D. Mo. 1972). In connection with asset sale (tax-free under old section 337) and liquidation of Target, Target paid Acquiror cash to reimburse Acquiror for payments to Target executives who had been terminated; payment *held* capital expenditure by Target because obligation arose from asset sale.

- ISP Position Paper, Restricted Stock Purchase in Merger & Acquisition, 91 TNT 90-33 (Apr. 23, 1991). When terminating a restricted stock plan, Target deducts the amount paid to employees that was vested prior to a plan amendment; amounts attributable to changes in plan made as part of acquisition plan must be capitalized as reduction to amount realized on sale.

- TAM 9125001 (Dec. 24, 1991), *modifying* TAM 8741001 (June 16, 1987). This technical advice memorandum establishes the Service's position that Seller may be entitled to an offsetting deduction for an assumed contingent liability that is included in its amount realized on a sale of a business. *See* part IV.D.2.a., below.

- TAM 9438001 (Apr. 21, 1994). Target deducts amounts Acquiror paid to acquire Target's employee stock options, stock appreciation rights, etc.

- TAM 9540003 (June 30, 1995). In connection with 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 deducts all amounts paid, including premium. *See also* FSA 200110020 (Dec. 6, 2000).

- TAM 9721002 (Jan. 24, 1997). Severance pay to Target executives deductible to Acquiror, even though plan instituted by Target in preparation for acquisition, because Acquiror, not Target, decided to terminate executives. *See also* TAM 9731001 (Jan. 31, 1997).

- TAM 199923045 (Oct. 9, 1998). Target employees were awarded cash performance units based on three years earnings, and they received the cash within 2-1/2 months of the fourth year. Awards were not "deferred compensation" and so were deductible by Target in the third year under the "all events" and "economic performance" tests. Thus, it appears that, if the performance units had vested on or before an acquisition date, Target would be entitled to the deduction.

C. Treatment of Expenditures That Are Expenses of Acquiror and Are Paid by Acquiror

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

1. Target's Treatment

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

2. Acquiror's Treatment

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

D. Treatment if Target's Liability Assumed

If Target's contingent liability is assumed by Acquiror, the assumption and payment is an adjustment to the sale price for the Target assets and is otherwise taken into account (usually as a deduction) by Seller, not Acquiror. The only questions relate to timing: Is the increase in sale price estimated and taken into account at closing or later when the liability becomes fixed or is paid? If the contingent liability results from a deductible cost, when is Seller entitled to the deduction? *See* part II.B.4.c., above. Because there is no actual payment from Acquiror to Target, this analysis is complicated for both parties. It leads to a series of different treatments, depending on the type of contingent liability involved. The aspect to watch is how the item would have been treated if it had stayed with Target until it became fixed and was paid. For this purpose, we will consider the following categories, *depending on how Target would have treated the item in the absence of an acquisition*:

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

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

1. Non-Deductible Items

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

a. Consequences to Target

(1) Expected Liability

If Target knows about the liability at closing, Target may adopt the installment method. In a section 338(h)(10) stock sale, under the Old 338 Regulations the installment method was not available, and there could have been an open transaction to Old T. Under the Current 338 Regulations, however, the results of a section 338(h)(10) stock sale are the same as those of an asset sale. *See* parts II.B.2.b. and II*.A.2., above, and part IV.D.2.a., below. Thus, regardless of whether the sale is an actual asset sale or a section 338(h)(10) stock sale, if Old T elects out of the installment method, Old T may have to report the fair market value of New T's liability assumption as amount realized at closing. No interest is imputed. When the liability is fixed or paid, Old T should realize the difference between the fair market value of the assumption (picked up at closing) and the amount actually paid. It is not clear, however, whether this pickup is gain or loss on a separate contingent purchase price obligation (as in the closed transaction method) or additional purchase price on the asset sale. *See* parts I.C.4.b. (installment method) and I.B.1.a. (election out), above.

(2) Surprise Liability

If the problem comes as a surprise after the closing, Old T recognizes additional gain on the sale when the liability is fixed or paid – as in any other open transaction, except there is no imputed interest or original issue discount. *See* parts I.B.1.b. and I.B.3., above; Reg. § 1.1274-5. Does the delayed gain recognition mean that the installment method applies? The answer is not clear, but the exception to imputed interest on assumptions of contingent liabilities suggests that this is a separate regime, so that it does not trigger the installment method.

b. Consequences to Acquiror

When the payment is made, Acquiror adds the amount paid to the purchase price of the Target assets and begins to take depreciation deductions at that time. *See* part I.D.3., above.

2. Deductible Items

If an assumed liability is for an item that is deductible (*e.g.*, a deductible environmental or employee benefit expense), Target and Acquiror both treat the item as an increase in the price paid for the assets. Target gets an offsetting deduction under general tax rules, with limited help as to timing under the economic performance regulations.

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

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

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

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

Great controversy resulted from this harsh conclusion. In TAM 9125001, IRS modified TAM 8741001 and interpreted Old Reg.§ 1.338-3(h)(1)(i) as allowing New T to deduct the contingent liability. The time of the deduction was not specified, however. (*See* parts IV.D.2.b.(3) and IV.D.2.b.(4), below). The Current 338 Regulations allow the deduction to Old T (or its successor, Seller) in a section 338(h)(10) stock sale and to New T after a section 338(g) election. *See* Reg. §§ 1.338-2(c)(7) (broad definition of "deemed sale tax consequences" to include deductions), 1.338-7(c)(1), 1.338-7(e) *Example (1)* (availability of deduction for payment of contingent liability not specified). For discussion of "deemed sale tax consequences," *see* part II.B.4.c., above. *See also Flood v. United States*, 133 F.2d 173 (1st Cir. 1943), and Rev. Rul. 75-154, 1975-1 C.B. 186 (pension payments made by former partners to former employees of terminated partnership deductible even though partnership business had been sold).

b. Consequences to Target – Timing Matters

(1) Inclusion in Amount Realized

It is uncertain whether Target's contingent liabilities assumed by Acquiror are included in the amount realized at closing. There is no real authority on this point.

(a) Inclusion at Closing

Treating the liability assumption as amount realized at closing would be consistent with the treatment of contingent purchase price under the closed transaction model. *See* part I.B., above. Treating the assumption of contingent liabilities as amount realized at closing could have extremely harsh results for Target. The amount realized on the assumption of the contingent liability would be offset by the corresponding deduction only later (perhaps much later) when the liability accrues under the "all events" test, and the economic performance test is met, *i.e.*, usually when the liability becomes fixed and is paid. *See* part IV.D.2.a., above.

(b) Inclusion When Fixed or Paid

Waiting until the liability becomes fixed before including it in Target's amount realized would be consistent with the exclusion of assumed contingent liabilities from the imputed interest/original issue discount regime and with the treatment of unaccounted-for acquisition debt under Reg. § 1.1001-2(a)(2). Also, if assumption of contingent liabilities by Acquiror is treated the same as contingent purchase price, Seller presumably would not be able to recognize a loss on the sale until all the contingencies have become fixed (in an open transaction). This harsh result would apply unless the assumption is treated as a closed transaction at closing with no further adjustments as the contingencies become fixed.

(2) Amount Included

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

(3) Reg. § 1.461-4(d)(5)

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

(4) Nuclear Power Plant Rulings

IRS appears sympathetic to preventing timing mismatch, at least where the contingent liability is fixed as a practical matter. In PLR 200126011 (Mar. 26, 2001) and in several similar rulings, Target sold a nuclear power station, including cash and investment assets in a non-qualified fund, and Acquiror assumed the liability for decommissioning the plant in the distant future. As to Target, IRS ruled that the present value of the assumed liability was included in Target's amount realized on the sale, but that the liability was sufficiently fixed so that Reg. § 1.461-4(d)(5) accelerated the deduction to match this additional amount realized. The analysis in this PLR has been changed by regulations dealing specifically with sales of nuclear power stations. Reg. § 1.338-6(c)(5). These regulations are discussed in part IV.D.2.c., below.

c. Consequences to Acquiror

Acquiror obtains basis and begins depreciation on the purchase price adjustment only when it pays the contingent item. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2)(i); Rev. Rul. 80-235, 1980-2 C.B. 229 (nonrecourse note not included in basis because speculative); PLR 9313025 (Jan. 5, 1993); PLR 9317005 (Jan. 15, 1993) (note under Federal clean coal program not included in basis).

In PLR 200126011 (Mar. 26, 2001), and similar rulings discussed in part IV.D.2.b.(4), above, IRS ruled that the liability to pay the costs of decommissioning a nuclear power station was contingent and so could not be reflected in the basis of the station until the liability became fixed. *See also*, *Merkel v. Commissioner*, 109 T.C. 463 (1997) (contingent liabilities not taken into account for purposes of section 108 insolvency exception, because taxpayer could not show it was more likely than not he would be called upon to pay them; court relied in part on GAAP treatment of contingent liabilities as support for this approach). Nuclear power station decommissioning costs are fully funded in a trust. In connection with a sale of a nuclear power station, the investments in this trust are transferred to Acquiror, but Acquiror may not withdraw these funds. Thus, the analysis in these rulings could result in severe distortion to Acquiror's basis. Under the section 1060 regulations, purchase price paid by Acquiror is allocated to the investments in the trust (Class I or Class II assets) before any amount can be allocated to the power station itself (a Class V asset). Yet the offsetting decommissioning liability funded by the trust is not included in Acquiror's basis until decommissioning – which could take place decades in the future. If the decommissioning liability and the trust investments are large enough, the investments could absorb the entire purchase price and leave no depreciable basis for the power station itself. To mitigate this harsh result, Treasury and IRS adopted temporary regulations in September 2004 (Reg. § 1.338-6T, T.D. 9158, 69 Fed. Reg. 55,740 (Sept. 16, 2004)) and final regulations in September 2007 (Reg. § 1.338-6(c)(5), T.D. 9358, 72 Fed. Reg. 51,703 (Sept. 11, 2007). Under both the temporary regulations and the final regulations, in an acquisition of a nuclear power station, Acquiror may elect unilaterally to treat the nonqualified fund trust as a separate corporation which owns the investment assets and has the decommissioning liabilities; a section 338(h)(10) election is treated as to this deemed sale of stock. As a result, if the value of the investments in the trust is exactly equal to the present value of the estimated decommissioning liability, Acquiror is deemed to pay $0 for the stock. Since the stock deemed purchased would be a class V asset, the amount actually paid by Acquiror for the other assets is allocated to those assets. The regulations solve the misallocation problem, but they cause the investments in the nonqualified trust to have a $0 basis until economic performance of the decommissioning liabilities. As these investments turn over, then, gain will be recognized. So the solution is only partial. *See* G. Pavin & G. Towne, "Basis Distortions on Nuclear Power Plant Purchases," 106 Tax Notes 565 (Jan. 31, 2005).

d. Character of Payments

There is no imputed interest on assumption of contingent liabilities. Reg. § 1.1274-5(a). Thus, as compared with a contingent purchase price, there is an artificial deferral of deductions to Acquiror, as well as a conversion of ordinary interest income into sale income (usually capital gain) with regard to Target.

3. Delayed Deductible Items – Section 404(a)(5)

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

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

If the fair market value of the deferred compensation payment can be determined, Target may have an increase in the amount realized at closing. *See* part IV.D.2.a., above. Target may not be entitled to the deduction for the deferred compensation, however, until the employee is paid and includes the payment in income. TAM 8939002 (June 15, 1989). There is no regulation that explicitly matches the gain recognition and the deduction. Reg. § 1.461-4(d)(5), which was published after the issuance of TAM 8939002, could be read as allowing this deduction at the time the amount is included in Target's amount realized in the sale. Although there is doubt on this point, this interpretation gains strength from Reg. § 1.461-4(d)(2)(ii)(A), which defers the deduction but only to extent not otherwise provided in regulations, revenue procedures or revenue rulings. This issue is discussed at length in a report submitted in response to the proposed regulations that became Reg. § 1.461-4. In this report, the New York State Bar Association argued that, in connection with the sale of a business, Target should be allowed its deduction at the same time it includes the assumed liability in its amount realized. NYS Bar Ass'n Tax Section Committee on Tax Accounting Matters, "Report of Proposed Regulations Relating to Economic Performance Requirements," 90 TNT 242-21 (Nov. 7, 1990). After this report was submitted, the proposed regulations were modified to broaden the scope of what is now Reg. § 1.461-4(d)(5) and to add the carve-out language to Reg. § 1.461-4(d)92)(iii)(A). *See also* TAM 199923045 (Oct. 9, 1998), discussed in part IV.B.3.f.(8), above, dealing with the scope of "deferred compensation."

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

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

4. Capital Items of Target

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

E. Treatment if Target's Liabilities Assumed – *James M. Pierce Corp.* Analysis

1. Prior Use of *Pierce* Analysis

At closing, Target may be viewed as paying Acquiror to assume its liability, in the form of reduced purchase price for the Target assets. This approach has been used, but only in the context of an asset sale under pre-1986 section 337. Under section 337, the deemed increase in sale price was tax-free to Target. Under current law, however, Acquiror would realize taxable income by *purchasing* a business – an unusual result to say the least. *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964) (where Acquiror assumed Target's obligation to provide subscribed-for newspapers, Target treated as receiving a higher price and then paying back part of the price to Acquiror is deductible expense; Acquiror's tax treatment not addressed directly). In Rev. Rul. 68-112, 1968-1 C.B. 62, dealing with a sale of a newspaper, IRS adopted the *Pierce* analysis on the Target side, ruling that Seller was entitled to a deduction for the hypothetical payment and repayment of part of the sale price. In Rev. Rul. 71-450, 1971-2 C.B. 78, IRS amplified Rev. Rul. 68-112 and applied the same reasoning to tax Acquiror on the same amount. These rulings were controversial within the government. *See* GCM 34418 (Feb. 3, 1971) (background to Rev. Rul. 71-450; Chief Counsel reaffirms *Pierce* and Rev. Rul. 68-112 in response to Department of Justice concerns). A few years later, in Rev. Rul. 76-520, 1976-2 C.B. 42, dealing with a subsidiary liquidation of a periodical corporation under section 334(b)(2), as then in effect, IRS ruled that the parent corporation had to capitalize the expenses it incurred after the liquidation to complete the subscriptions to the former subsidiary's periodical. No mention was made of section 455, *Pierce*, Rev. Rul. 68-112 or Rev. Rul. 71-450, or of a current deduction to the liquidating subsidiary or taxable income to the parent at the time of the liquidation. This ruling could suggest that the *Pierce* analysis is applied only where Target had elected to defer income on uncompleted subscriptions under section 455.

2. Limits on Use of the *Pierce* Analysis

Until recently the *Pierce* analysis was applied only in the publishing industry and even then to account for prepaid subscription income that is allowed tax deferral under section 455. TAM 9823002 (Feb. 5, 1998) (subscription income deferred by partnership treated as partnership "liability" that increases basis in partnership interests). The *Pierce* analysis now may apply to deemed asset sales for insurance companies. Such transactions would be taxed as assumption-reinsurance transactions. Reg. §§ 1.338-1(a)(2), 1.338-11. In a recent preamble to final regulations (T.D. 9376, 73 Fed. Reg. 2416, 2417 (Jan. 16, 2008)), the government has applied the *Pierce* analysis (including taxable income to Acquiror) whenever Acquiror assumes Target's obligation to provide goods or services for which Target has deferred taxable income. Although the regulations themselves deal with the treatment of minority shareholders in section 332 liquidations (Reg. §§ 1.1502-80(g)(2), 1.1502-80(g)(6) *Example 3*), the reasoning in the preamble would seem to apply to asset acquisitions as well. *See* GCM 34418 (Feb. 3, 1971). Neither the preamble nor the regulation applies, however, to the more common situation of an assumption of a contingent liability. For a recent discussion of this issue (referred to as the "fee model" vs. the "purchase model") and the authorities, *see* R. Scarborough, "Property Purchase or Payment in Kind? The *Oxford Paper* Conundrum," Tax Forum No. 608 (May 5, 2008).

3. Consequences of *Pierce* Analysis

The *Pierce* analysis is extremely complex and, in the post-*General Utilities* world, it is unfavorable to both Target and Acquiror.

a. Consequences to Target

- Target adds the fair market value of Acquiror's liability assumption to its amount realized in the asset sale and is deemed to make an offsetting payment to Acquiror. Thus, Target's amount realized at closing is increased.
- Target is deemed to make an offsetting payment to Acquiror to compensate Acquiror for assuming the liability. The character of this deemed payment has not been explored. It should have the same character as an actual payment by Target of the underlying obligation would have (as discussed in part IV.D., above):
  - •• If a payment by Target of the underlying obligation would be non-deductible (*e.g.*, a Federal income tax payment as discussed in part IV.D.1., above), the deemed payment by Target to Acquiror also should be non-deductible to Target.
  - •• If a payment by Target of the underlying obligation would be deductible currently (as discussed in part IV.D.2., above), the deemed payment by Target to Acquiror also should be deductible to Target at the time the acquisition closes. *See* Reg. § 1.461-4(d)(5).
  - •• If a payment by Target of the underlying obligation would be deductible on a delayed basis (as discussed in part IV.D.3., above), the deemed payment by Target to Acquiror should be deductible to Target on the same delayed basis.
  - •• If a payment by Target of the underlying obligation would be a capital item to Target (as discussed in part IV.D.4., above), the deemed payment by Target to Acquiror should be treated as part of the same capital asset involved, *i.e.*, a reduction in the amount realized on (or an increase in the basis of) the asset.
- Alternatively, the deemed payment could be treated as a separate asset transferred to Acquiror as part of the asset sale. Would this asset be Class I (cash) or Class V (a non-marketable financial instrument deemed issued by Target)?

b. Consequences to Acquiror

The *Pierce* analysis would have two offsetting consequences to Acquiror as well:

- Acquiror would be deemed to increase its purchase price for the assets by the amount it is deemed to pay (but does not actually pay) to Target at closing. Acquiror should be able to depreciate the assets taking the deemed payment into account immediately, even though the liability is contingent (*see* part IV.D., above), because Acquiror would be considered to have paid this extra amount and then received it back again.
- Acquiror may have taxable income for the payment it is deemed to receive (but does not actually receive) from Target at closing. Then, when the liability is paid or accrued, Acquiror should have a deduction or loss for the payment. This payment by Acquiror should not be added to Acquiror's basis in the assets acquired from Target.

c. Alternative Analysis

As an alternative to a deemed cash receipt treated as taxable income, may Acquiror treat the cash deemed received as one of the assets purchased in the acquisition (presumably a Class I or Class V asset)?

d. A Suggested Tweak

If the *Pierce* analysis is used, the results would be more sensible if the analysis were limited to Target (gain and offsetting deduction), while Acquiror is allowed a step-up in the basis of the purchased assets subject to the normal accounting rules applicable to assumptions of fixed or contingent liabilities. *See* part I.B.2.a., above.

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

The current law, especially the *Pierce* analysis, is very difficult, and it is tempting to come up with a simpler scheme.

1. Acquiror Steps into Target's Shoes

Some commentators have proposed allowing Acquiror to step into Target's shoes and take deductions when Target otherwise would have been allowed the deductions. ABA Section of Taxation Legislative Recommendation 87-2, 1987-1 ABA Reports 105, 6 ABA Tax Section Newsletter 23, ABA Section of Taxation Policy 1950-1997, 17; NYSBA Tax Section Committee on Alternative Minimum Tax, "Report on the Federal Income Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions," 49 Tax Notes 883 (Nov. 19, 1990).

- This system would have the advantage of keeping Target out of the matter. Target may not be able to find out about the contingent liabilities that become fixed after the closing, at least if there is no indemnity.
- This system would treat a contingent liability differently from a fixed liability or contingent purchase price and as more like an unfavorable executory contract or other business arrangement (*e.g.*, an above-market lease for the lessee) that reduces the value of the business itself. *See* section 1274(c)(4) (no imputed interest on purchase of assets subject to favorable or unfavorable financing). A recent example of this type of analysis appears in PLR 200730014 (July 27, 2007). There, a purchaser of a gas marketing business paid customers to terminate their contracts to buy gas at low fixed prices and substitute contacts to buy at fluctuating prices. IRS ruled that, even though the contracts were unfavorable to the purchaser, the payments could be deducted currently, because the purchaser's obligations were contingent on gas purchases and market fluctuations, and because the contracts were not taken into account in determining the purchase price for the business.
- In the case of a non-deductible expenditure, a step-into-the-shoes approach would benefit Seller at the expense of Acquiror, because of the absence of a purchase price adjustment.
- In fact, this is probably what many parties actually do, by treating assumed liabilities or Acquiror expenditures, and IRS seems not to have been active in challenging this result.

2. Surprise Expenses

One commentator has suggested allowing the step-in-the-shoes result when the contingent liability is a surprise and is not reflected in purchase price. P. Canellos, "Reasonable Expectations and the Taxation of Contingencies," 50 Tax Law. 299 (1997). The Tax Court has rejected this analysis, however, and required Acquiror to capitalize the cost of an unexpected judgment against it in a patent infringement case involving the Target business. *Illinois Tool Works, Inc. v. Commissioner*, 117 T.C. 4 (2001), *aff'd* 355 F.3d 997 (7th Cir. 2004).

3. Discounted Deduction

Other commentators have argued that a step-into-the-shoes approach would allow Acquiror the benefit of deductions sooner than is appropriate (because Acquiror would get an immediate full deduction, not depreciation). As a result, they suggest a discounted deduction, or "haircut," for Target liabilities assumed by Acquiror. C. Crane, "Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless?," 48 Tax Notes 225 (July 9, 1990); D. Halperin, "Assumption of Contingent Liabilities on Sale of a Business," 2 Fla. Tax Rev. 673 (1996). This approach too would exclude Target from the matter.

4. IRS Guidance Not Likely

This issue was in the Treasury-IRS Business Plan for 1995, but it was deleted from the 1996 Business Plan, and it has not been in a Business Plan since that time.

G. Treatment of Indemnity Payment by Seller to Acquiror

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

1. Seller's Treatment of Indemnity Payment When Made

Indemnity payments by Seller to Acquiror that integrally relate to or arise from an asset sale, such as payments made pursuant to guarantee or warranty clauses, are treated as reductions in the purchase price, under *Arrowsmith v. Commissioner*, 344 U.S. 2 (1952). Thus, Seller may take a capital or ordinary loss depending on the character of the assets sold. *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422 (1949) (payments and attorney fees paid for a breach of warranty claim on a real estate sale were treated as capital losses relating back to the sale); *Rees Blow Pipe Manufacturing Co. v. Commissioner*, 41 T.C. 598 1964 (nonacq.), *aff'd per curiam*, 342 F.2d 990 (9th Cir. 1965) (a payment made pursuant to a legal claim arising from a non-taxable capital asset exchange was treated as relating back to the exchange); *Boothe v. Commissioner*, 768 F.2d 1140 (9th Cir. 1985, *rev'g on different grounds*, 82 T.C. 804 (1984) (payments made pursuant to a breach of warranty claim on a capital asset sale were treated as relating back to the sale). Seller may remain entitled to an ordinary deduction for indemnity payments that do not integrally relate to the asset acquisition or that cover retained liabilities which would have been deductible business expenses had no sale occurred. Permitting Seller to deduct the retained liabilities would be consistent with *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943), in which former partners were entitled to deduct retained pension liability payments after selling their former partnership's assets. *See also* Rev. Rul. 75-154, 1975-1 C.B. 186 (permitting former partners to deduct retirement payments to a retired former partner after the termination and liquidation of their former partnership).

Seller may also be entitled to an ordinary deduction for indemnity payments arising from continued business operations. In PLR 200127022 (Apr. 4, 2001), a doctor who sold his practice and later violated a restrictive covenant in the sale agreement was permitted to deduct the damages, because the payments arose from the doctor's continued business operations rather than relating back to the sale.

2. Acquiror's Treatment of Indemnity Payments When Received

Like Seller's treatment, Acquiror's treatment of reimbursed expenses may depend on whether the indemnity payments relate back to the sale.

Where the indemnity payment is treated as a reduction in the price paid to Seller (rather than a deductible retained liability as in *Flood*), Acquiror may be permitted to deduct the underlying expense and reduce its basis in the purchased assets to account for receipt of the indemnity payment. Whether Acquiror may deduct the expense should depend on the nature of the expense with respect to Acquiror. Under this treatment, the indemnity payment would not be income to Acquiror when received because the payment would already be accounted for in the reduced purchase price.

In contrast, where Seller remains entitled to deduct an indemnity payment relating to retained liabilities, Acquiror should be treated as if it never assumed the Seller's liability to the extent of the indemnity. Therefore, Acquiror would not be entitled to a deduction or make any adjustment to asset basis.

3. Possible Alternative

As a conceptual matter, an indemnity from Seller to Acquiror could be viewed as a separate Class V asset sold by Target to Acquiror, like a note, to which part of the purchase price would be allocated. Gain or loss would be recognized to Acquiror based on the difference between the value of that Class V asset and the amount actually received.

V. Contingent Liabilities in Taxable Stock Acquisitions Without Section 338(h)(10) Elections

A. Contingent Liabilities in General

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

B. Income and Deductions

1. Taxable Year of Deduction

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

a. Consolidated Return

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

- If the "same-day" rule of Reg. § 1.1502-76(b)(1)(ii)(A)(i) applies, the deduction belongs in Seller's consolidated return for the year of the sale (*i.e.*, the deduction is claimed on the day of the sale but before the sale is effective).
- If the "next-day" rule of Reg. § 1.1502-76(b)(1)(ii)(B) applies, the deduction belongs in Target's first separate return, which could be Acquiror's consolidated return for the year of the sale (*i.e.*, the deduction is claimed on the day after the sale).
- Generally, Seller and Acquiror may decide by agreement whether the "same-day" rule or the "next-day" rule will apply to any particular deduction, so long as the allocation is reasonable and consistently applied. Reg. § 1.1502-76(b)(1)(ii)(B).

- If a "ratable allocation" under Reg. § 1.1502-76(b)(2)(ii)(A) is available and is made, the deduction belongs partly in each return. A payment on an employee stock option, and the like, as a result of an acquisition, is an "extraordinary item," and ratable allocation is not available. Reg. §§ 1.1502-76(b)(2)(ii)(A) and 1.1502-76(b)(2)(ii)(C)(9).

b. Section 404(a)(5)

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

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

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

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

Reg. § 1.1502-11(b) provides that Target's loss is used to the extent it absorbs group income or gain other than gain on the sale of Target stock. The unused loss is carried to other years.

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

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

C. Contingent Liabilities as Built-in Loss

1. Section 382(h)

Contingent liabilities may be unrealized built-in losses under section 382(h)(6)(B). If so, and if Target has a net unrealized built-in loss, a section 382 limitation could apply to the deduction when the contingencies become fixed and the liability results in a deduction. It is not clear whether normal contingent liabilities will be treated as built-in loss items for this purpose. The legislative history of section 382(h) states:

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

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

2. Consolidated Return Matters

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

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

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

b. Separate Return Limitation Year Rules Applied to Target

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

c. Prior Invalidated Loss Disallowance Rule Applied to Seller

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

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

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

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

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

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

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

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

(1) General

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

(a) Basis Redetermination Rule

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

(b) Basis Reduction Rule

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

(c) Attribute Reduction Rule

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

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

Target's attributes are subject to reduction in the following order: (i) loss carryovers, (ii) deferred deductions and (iii) basis of assets (except cash and with special rules for lower-tier subsidiaries and marketable securities). In general, if the attribute reduction amount exceeds the attributes available for reduction, that excess attribute reduction amount has no further effect.

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

(2) Effect of Target's Contingent Liability

If Target has contingent liabilities that are taken into account in determining the purchase price of the Target stock, the contingent liabilities can cause Seller to recognize a net stock loss on the sale of the Target stock because the contingent liabilities reduce the value of the Target stock but do not reduce Seller's basis in the Target stock. Contingent liabilities can also result in a corresponding net inside loss, because contingent liabilities do not reduce Target's inside attribute amount. Thus, the presence of contingent liabilities may require Target to reduce its attributes.

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

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

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

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

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

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

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

Seller may elect to reduce its basis in the Target stock (or reattribute Target's loss carryovers, not present in this example). Thus, the value of the stock loss deduction relative to the lost value of Target's asset basis must be considered. For instance, if Seller does not anticipate that it will recognize capital gains against which the loss on the Target stock could be offset, Seller may agree to elect to reduce its stock basis in exchange for a higher purchase price reflecting the unreduced value of Target's asset basis. On the other hand, if Acquiror does not anticipate causing Target to sell L1 or L2 or otherwise recover its basis in L1 or L2, Acquiror may agree to accept the basis reduction and allow Seller to deduct the capital loss on the sale of the Target stock.

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

The facts are the same as in Example 1, except that Target retains the $500 cash earned in Years 1-5. At the time of the sale of the Target stock to Acquiror for $400, Seller's basis in the Target stock is $650; Target's basis in L1 is $150; and its basis in the cash is $500. Target has no liabilities other than the contingent environmental liability.

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

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

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

D. Indemnity by Seller for Target's Contingent Liabilities

1. Treatment to Seller

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

Commissioner, T.C. Memo 1971-327; PLR 9842008 (Oct. 16, 1998); FSA 200147013 (July 10, 2001); FSA 199942025 (Oct. 22, 1999).

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

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

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

2. Treatment to Acquiror and Target

a. Indemnity of Target Liability Paid by Seller to Target

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

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

Addressing the overarching tax benefit issue, courts and IRS hold that where Target is otherwise entitled to a deduction, Target is not prohibited from claiming the deduction merely because the expense is indemnified. In *VCA Corp. v. United States*, 77-2 USTC ¶¶ 9554, 9736, 40 AFTR 2d ¶ 77-5429, *unpublished opinion noted* 566 F.2d 1192 (Ct. Cl. 1977), a reorganization case, the court allowed the deduction. IRS has since agreed with this conclusion. Rev. Rul. 83-73, 1983-1 C.B. 84. *See* part X.C.2.a., below. In GCM 38977 (Apr. 8, 1982), IRS concluded that the treatment for reorganizations would also apply to taxable stock purchases, and this view has been followed in private rulings and field service advice. PLR 8429014 (Apr. 16, 1984); PLR 9029058 (Apr. 25, 1990); FSA 200147013 (July 10, 2001).

b. Reimbursement of Tax Benefit

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

c. Settlement on Indemnity Obligation

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

E. Other Indemnities or Compensation Payments Between the Parties

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

1. Payments as Part of the Original Transaction

In *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo 1977-429, a broker agreed to indemnify Acquiror for its inability to sell a Target asset unwanted by Acquiror. In an *Arrowsmith*-like analysis, the court treated the indemnity payment as a reduction in Acquiror's purchase price for the Target stock. The fact that a third party made the payment to Acquiror meant that Seller's treatment was not affected, but Acquiror's basis in the Target stock was reduced. There was no taxable income to Target. In *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976), *aff'd on other grounds*, 558 F.2d 128 (2d Cir. 1977), Seller effectively guaranteed a projected level of earnings from one of Target's assets via an indemnity agreement. Ultimately, the earnings fell short of the guaranteed level. Citing *Arrowsmith*, the Tax Court treated Seller's indemnity payments as adjustments to sale price and therefore as capital losses. For examples of indemnity payments not treated as relating back to their respective sales, see *Inland Asphalt Co. v. Commissioner*, 756 F.2d 1425 (9^{th} Cir. 1985) (an indemnity payment related to a previous distribution-leaseback transaction between Target and Seller rather than to the sale); TAM 200427023 (July 2, 2004).

2. Payments as Part of a New Transaction

In PLR 200518014 (Dec. 30, 2004), C, a consolidated group parent, sold the stock of two subsidiaries (X and Y) to S, another consolidated group parent. The sale agreement provided that, if X or Y incurred a loss after the closing, the loss would not be carried back to a C year. After the closing, the law was changed to allow net operating loss ("NOL") carrybacks for five years instead of two years. In the fourth year after closing, X and Y incurred NOLs. C and B reached a new agreement that the NOLs would be carried back to a C year, that C would file the refund claims, and that C would retain 1/3 of the refund and pay the remaining 2/3 of the refund to B. IRS ruled that the payment by C to B was not a return of purchase price under *Arrowsmith*, because it was not made pursuant to the original agreement. Instead, it ruled that the payment was ordinary income to B and deductible to C. Presumably, C retained 1/3 of the refund tax-free. This ruling was sharply criticized for disregarding the regulations on allocating tax liabilities among members of consolidated groups and so suggesting that C could retain the refund tax-free. J. Prusiecki, "Brilliant Advocacy or Very Good Luck?" 107 Tax Notes 1751 (June 27, 2005). The ruling was revoked retroactively without explanation. PLR 200613022 (Oct. 28, 2005).

TAX-FREE TRANSACTIONS

VI. Contingent and Escrowed Stock in General

A. Background and General Treatment

The tests for tax-free treatment of contingent and escrowed stock in tax-free reorganizations were developed in *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960), and *Hamrick v. Commissioner*, 43 T.C. 21 (1964) (*acq. in result only*). In these cases, IRS argued that contingent and escrowed stock arrangements did not constitute "stock" that could be received tax-free, but the courts rejected this argument. In response, IRS first adopted a policy of issuing advance rulings on tax-free reorganizations involving contingent stock, but only if the right to receive the contingent stock was not separately transferable. Rev. Rul. 57-586, C.B. 1957-2, 249; Rev. Rul. 66-112, 1966-1 C.B. 68; Rev. Rul. 67-90, 1967-1 C.B. 79. In view of these authorities, the Target shareholders may receive contingent and escrowed stock tax-free under section 354, if appropriate guidelines are observed. It should also be noted that the receipt of contingent and escrowed stock are not subject to tax under section 305(b), because the contingent or escrowed stock is not issued "with respect to stock" of the issuer. J.P. Holden, "Unraveling the Mysteries of Section 305," 36th Ann. N.Y.U. Inst. Fed Tax'n 781, 813 (1978).

B. Advance Ruling Guidelines

Ultimately, IRS developed advance ruling guidelines in Sections 3.03 and 3.06 of Rev. Proc. 77-37, 1977-2 C.B. 568, and then revised them in Rev. Proc. 84-42, 1984-1 C.B. 521. The tests relate to the following factors:

- Business purpose for the arrangement (usually that the parties cannot agree on a price).
- Time limit of 5 years until all stock is returned or issued.
- Cap on amount of contingent or escrowed stock: no more than 50% of all the stock issued.
- Rights to contingent stock not assignable, or at least not negotiable or readily marketable.
- Only additional stock may be issued, not other property.
- Contingencies are subject to objective determination; contingencies are not in the control of either or both of the parties or contingencies relating to death, continued employment of a shareholder or Target's tax liability.
- Any escrowed stock is issued and outstanding, and Target shareholders are entitled to vote the stock and receive dividends; contingent stock is not issued and outstanding and involves no dividends or voting rights.

If these tests are met, contingent stock and escrowed stock both are treated as stock that qualifies for tax-free treatment, even though contingent stock may represent a promise to issue stock in the future. Thus, contingent stock and escrowed stock count favorably toward the continuity-of-interest test and the "solely for voting stock" test. An example of a private ruling using these tests is PLR 9827027 (Apr. 3, 1998). For a discussion of the case law and these tests, see R. Willens, "Contingent Stock Acquisitions Should Gain Popularity in Uncertain Times," Daily Tax Report June 23, 2003.

C. Commentary

Some commentators have argued that the advance ruling guidelines are more restrictive than the case law would suggest. D. Tillinghast, "Contingent Stock Pay-Outs in Tax-Free Reorganizations," 22 Tax Law. 467 (1969); R. Jacobs, "Escrows and Their Tax Consequences," 39 N.Y.U. Inst. Fed. Tax'n § 5 (1981); J.C. Fleming, "Rethinking Contingent Price Reorganizations," 9 J. Corp. Tax'n 3 (1982). Nevertheless, the advance ruling guidelines have become the usual standards in structuring transactions.

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

1. Background

To satisfy the continuity-of-interest test, at least 40% of the consideration received for the Target stock must consist of stock of Acquiror (or in some instances Acquiror's parent). Reg. § 1.368-1T(e)(2)(v) *Example (1)*. Generally, consideration is valued for this purpose at closing. A long-standing problem concerns the common situation in which Target and Acquiror agree on pricing terms in a contract, and the closing takes place later. If the value of the Acquiror stock declines, continuity may be jeopardized.

2. Proposed Regulations

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

3. Temporary Regulations

On March 19, 2007, temporary regulations on this subject were adopted. T.D. 9316, 72 Fed. Reg. 12974 (March 20, 2007). In response to comments, the temporary regulations allow the value of the Acquiror stock to be fixed as of the day before the binding contract for continuity purposes, even if there is contingent consideration, if (a) the transaction would satisfy the continuity test without the contingent consideration, and (b) the contingent consideration does not prevent the exchanging Target shareholders from being subject to the economic benefits and burdens of owning Acquiror stock. Reg. §§ 1.368-1T(e)(2)(iii)(B), 1.368-1T(e)(2)(v) *Examples (10), (11), (12)*. If the contingency to which the consideration is subject relates to the value of the Acquiror stock (*e.g.*, a collar), then, the rule does not apply, and the value of the Acquiror stock is measured at the time of closing.

The temporary regulations do not explicitly address issuances of contingent consideration after closing. Apparently, the continuity test is applied again taking this consideration into account, but the value of each share of the Acquiror stock is measured as of the day before the contract is entered into. The rule on escrowed consideration is similar to the rule in the proposed regulations. If consideration was escrowed, the rule applies, provided the escrow is “to secure target’s performance of customary pre-closing covenants or customary pre-closing target representations or warranties.”

The temporary regulations expired on March 19, 2010, but taxpayers may continue to rely on them. Notice 2010-25, 2010-14 I.R.B. __.

The tax bar has had mixed response to the temporary regulations. Some have stated that the “signing date” rule should be broadened to include contingent stock and “collar” arrangements, any other situations. Amer. Bar. Ass’n Section of Tax’n, “Comments on Temporary and Proposed Regulations Regarding the Measurement of Continuity of Interest Under Section 368” (Feb. 26, 2010).

VII. Escrowed Stock

A. Escrowed Stock as “Stock”

If escrowed stock satisfies the tests in Rev. Proc. 84-42, it is treated as “stock” qualifying for tax-free treatment. *See* part VI.B., above.

B. Treatment at Closing

1. General

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

2. Stock Basis

Because escrowed stock is considered to belong to the Target shareholders, the stock is part of the reorganization price, and the escrowed shares take part of the overall substituted basis under section 358.

3. No Imputed Interest

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

4. Effect on Continuity of Interest

See part VI.D., above.

C. Effect of Return of Escrowed Stock to Acquiror

1. Possible Analyses

If escrowed stock is returned to Acquiror, *e.g.*, because of indemnity obligations, there may be either (a) an adjustment to the reorganization purchase price (as in a taxable acquisition) or (b) a separate redemption of the stock by Acquiror, treated as a sale or a dividend under section 302.

2. Returned Stock Valued at Closing

Generally, return of the escrowed stock is treated as an adjustment to the purchase price if the returned stock is valued, for purposes of the transaction, based on its value at the time of the original acquisition. Rev. Rul. 76-42, 1976-1 C.B. 102; Rev. Rul. 76-334, 1976-2 C.B. 108. In this case, the remaining shares take on the part of the substituted basis that had belonged to the escrowed shares, and there is no gain or loss to the former Target shareholders. If any of the other shares have been sold in the meantime, gain or loss is recognized under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), to account for the basis adjustment.

3. Changes in Stock Value Taken into Account

If the formula for the number of shares returned takes into account changes in Acquiror stock value since the transaction, the return of the escrowed stock is a separate stock redemption by Acquiror. The redemption price is the discharge of the shareholders' indemnity obligations (*i.e.*, the value of the escrowed stock that is redeemed). Rev. Rul. 78-376, 1978-2 C.B. 149. According to this ruling, the same amount is added to the redeemed shareholders' basis in its *remaining* stock of Acquiror. Query whether the indemnity amount should be added to the shareholders' basis in *all* of the Acquiror stock received in the original transaction (including the escrowed stock redeemed). If the redemption is treated as a sale under section 302(a), then the redeemed shareholders recognize gain or loss based on the current value of the returned stock and its basis. If the redemption is treated as a dividend under section 302(d), then, under Reg. § 1.302-2(c), the basis of the redeemed stock shifts to the other Acquiror stock held by the shareholder.

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

Under the final continuity-of-interest regulations, Acquiror stock issued in a potential reorganization and then redeemed by Acquiror, "in connection with" the reorganization, counts against continuity. Reg. § 1.368-1(e). Does this rule apply to escrowed stock? The regulations do not cover this point, but, in an informal presentation, a National Office official has made the following observations:

- There is a good chance that escrowed stock will be treated as issued in the acquisition and so counted favorably for continuity purposes.
- There is a good argument that return of escrowed stock would be treated as a separate transaction, not "in connection with" the reorganization.

For an example of this approach, *see* Rev. Rul. 76-334, 1976-2 C.B. 108. There, after a type-B reorganization, escrowed stock was returned for cash equal to half the stock value. IRS said the cash was received in a separate redemption and did not prevent the transaction from qualifying as a type-B reorganization.

VIII. Contingent Stock

A. Contingent Stock as "Stock" – Continuity of Interest

Contingent stock is treated as "stock" for reorganization purposes, so long as the advance ruling guidelines are met. *See* part VI.B., above. The value of the fixed and contingent stock may be measured on the day before a binding contract is entered into. *See* part VI.D., above.

B. Treatment at Closing

The regimes for contingent stock and escrowed stock are different. Contingent stock is treated as issued only when the contingency disappears and the stock is actually issued. IRS has been concerned about how to determine stock basis when the contingent stock is issued, but it is well settled now that basis is reallocated among all the shares issued in the reorganization.

C. Second Acquisition

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

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

1. Imputed Interest

Imputed interest is another feature of contingent stock. The courts and IRS have long been consistent in concluding that the deferred issuance of contingent stock is a deferred payment and includes imputed interest. *Tribune Publishing Co. v. United States*, 836 F.2d 1176 (9th Cir. 1987); *Kingsley v. Commissioner*, 662 F.2d 539 (9th Cir. 1981); *Vorbleski v. Commissioner*, 589 F.2d 123 (3d Cir. 1978); *Katkin v. Commissioner*, 570 F.2d 139 (6th Cir. 1978); *Fox v. United States*, 510 F.2d 1330 (1974); *Jeffers v. United States*, 556 F.2d 986 (Ct. Cl. 1977); *Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga. 1980); *Cocker v. Commissioner*, 68 T.C. 544 (1977); *Catterall v. Commissioner*, 68 T.C. 413 (1977); *Solomon v. Commissioner*, 67 T.C. 379 (1976); Rev. Rul. 72-35, 1972-1 C.B. 139; Rev. Rul. 70-300, 1970-1 C.B. 125, *clarified*, Rev. Rul. 72-32, 1972-1 C.B. 48; Rev. Rul. 73-298, 1973-2 C.B. 173.

2. Interest Income to Target Shareholders as Received

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

3. Deduction to Acquiror

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

- A contingent stock obligation may not be a "debt instrument" within the meaning of section 163(l). Reg. § 1.483-4(b) *Example 2*, states that a contingent stock obligation is "not a debt instrument for federal income tax purposes," so that there is no original issue discount under section 1274, but instead interest is imputed on the cash method under section 483.

- In a private ruling, IRS declined to apply section 163(l) where a debt would be paid in stock only in certain unlikely events. PLR 200052027 (Sept. 29, 2000).
- Rev. Rul. 2002-31, 2002-22 I.R.B. 1023, holds that the issuer of convertible debt with contingent interest – based on the value of the issuer's stock – may deduct original issue discount-type interest on the "noncontingent bond method" of Reg. § 1.1275-4(b). It also holds that the interest is deductible, in spite of section 163(l).

4. Advantage of Escrowed Stock

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

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

If contingent stock is issued, the former Target shareholders adjust their basis in their Acquiror stock to allocate an appropriate part of their substituted basis under section 358 to the contingent shares. Contingent shares received as imputed interest take full fair market value basis. It is not clear whether the former Target shareholders may identify specific shares with specific basis, or whether they must allocate all the basis (including the fair market value basis resulting from imputed interest income) among all the shares received. *See* Reg. § 1.1012-1(c) (FIFO and identification rules for sales of separate blocks of stock). *But see* Rev. Rul. 55-355, 1955-1 C.B. 418 (average basis used for Acquiror stock received in tax-free reorganization in exchange for several blocks of Target stock).

F. Effect of Non-Receipt by Former Target Shareholders

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

G. Nonvested Compensatory Stock

1. Issue

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

2. Partial Solution

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

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

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

IX. Options to Acquire Stock

A. Treatment of Options as Zero-Principal Securities

Options to acquire stock (including warrants) received in tax-free reorganizations are treated as securities with a zero principal amount. Reg. §§ 1.354-1(e), 1.355-1(c) and 1.356-3(b); T.D. 8752, 63 Fed. Reg. 409 (Jan. 6, 1998). The effect of this treatment is to extend nonrecognition to the receipt of options in a reorganization. I.R.C. § 356(a)(1)(B); Reg. § 1.356-3(c) *Examples 7, 8*, and *9* (illustrating the effect of a right to acquire stock having no principal amount). Nonrecognition treatment prevails if the Target shareholder exchanges (1) Target options or securities for Acquiror options or (2) Target stock for Acquiror options and Acquiror stock.

B. Treatment of Options as Boot in Certain Exchanges

Options received in a reorganization are treated as taxable boot if the Target shareholder exchanges Target stock for Acquiror options. Reg. § 1.354-1(d) Example 4; I.R.C. §§ 354(a)(2)(A), 355(a)(3) and 356(d). Acquiror's nonqualified preferred stock ("NQPS") or Acquiror's NQPS options received in exchange for anything other than Target NQPS or Target NQPS options is also treated as boot. Reg. § 1.356-6(a). *See* T.D. 8882, 65 Fed. Reg. 31,078 (May 16, 2000). In these situations, Target shareholders recognize gain up to the fair market value of the options. I.R.C. § 356(a)(1); Reg. § 1.356-1(a). The regulations provide no guidance on the valuation of options, but presumably principles analogous to the valuation of options in other contexts would apply. *See, e.g.*, Rev. Rul. 59-60, 1959-1 C.B. 237; I.R.C. §§ 83, 305, 307(b)(1). *See generally*, part I.B.1.e., above, for discussion of receipt of Acquiror options in taxable acquisitions.

C. Effect on Continuity of Interest

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

X. Target's Contingent Liabilities

A. "Assumption" of Liabilities

Section 357 governs much of the treatment of liabilities assumed in tax-free acquisitions. As long as liabilities are not assumed for a tax avoidance purpose, (and, in some instances, as long as the amount o f the liabilities does not exceed the basis of the property transferred by the same transferor), the liabilities are not treated as taxable "boot." Within the past several years there have been legislative and regulatory efforts to clarify what is meant by "assuming" a liability. The changes were intended to prevent abuse and to eliminate non-economic results. Treasury and IRS have issued an Advance Notice of Proposed Rulemaking soliciting comments on a variety of issues under section 357(d). Advance Notice of Proposed Rulemaking, Liabilities Assumed in Certain Transactions (Announcement 2003-37, REG-100818-01, RIN 1545-A474, 68 Fed. Reg. 23,931 (May 6, 2003).

1. Cross-Collateralized Debt – Section 357(d)

One transaction involved the transfer of several items of property, all subject to the same liability, to separate corporations, with the full amount of the liability being added to the basis of each property. In 1999 Congress amended sections 357(a) and (c) and enacted section 357(d) to clarify the concept of "assumption" of a liability. Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(1) (106th Cong., 1st Sess. 1999).

a. Recourse Liabilities

A recourse liability is now considered assumed only if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy the liability. I.R.C. § 357(d)(1).

b. Nonrecourse Liabilities

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

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

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

3. Contingent Liability Shelters – Notice 2001-17, Section 358(h) and Section 362(e)

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

Notice 2001-17, 2001-2 C.B. 730, designated this transaction as a "listed" transaction under Temp. Reg. § 1.6011-4T(b)(2) and stated the intention to challenge these contingent liability tax shelters. Losses on transactions occurring before the effective date and on transactions not subject to section 358(h) (discussed below) will be challenged based on a number of broad-based arguments. In Rev. Proc. 2002-67, 2002-43 I.R.B. 733, IRS provided two alternative procedures to settle cases involving these transactions.

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

Section 358(h), enacted in 2000, eliminates this tax shelter with a new loss disallowance rule.

- Section 358(h)(1) reduces the basis of stock to the extent that (a) it exceeds the stock's fair market value, and (b) a liability was assumed by the transferee corporation in exchange for the stock.
- For purposes of section 358(h), "liabilities" include contingent liabilities, even those that have not otherwise been yet taken into account under the Code. Section 358(h) is effective for transfers on or after October 18, 1999. I.R.C. § 358(h)(3).
- Under section 358(h)(2), stock basis is not reduced by a liability, if the assets transferred to the corporation as part of the exchange include either (*a*) the trade or business associated with the liability, or (*b*) substantially all of the assets associated with the liability. In regulations, however, Treasury used its authority under section 358(h)(2) to eliminate the exception for transfers of substantially all of the assets associated with a liability. Reg. § 1.358-5, T.D. 9207, 70 Fed. Reg. 30,334 (May 26, 2005), T.D. 9397, 73 Fed. Reg. 26,321

(May 9, 2008). A similar rule was adopted for transfers to partnerships. *See* parts X.A.4.b. and X.A.4.c., below.

Section 362(e)(2), enacted in the American Jobs Creation Act of 2004, was intended to prevent double deductions resulting from transfers of built-in loss property to corporations. It reduces the basis of the transferred property from a carryover basis to fair market value. This provision generally does not apply, however, to contingent liabilities. It applies only when the basis of property transferred to a corporation is greater than the fair market value of the property.

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

4. Partnership Liabilities

a. Regulations in General

Reg. §§ 1.358-7, 1.752-1, 1.752-6 and 1.752-7, T.D. 9207, 70 Fed. Reg. 30,334 (May 26, 2005), deal with variations on this tax shelter involving partnerships. The regulations apply, however, to situations well beyond any specific shelter. The implications of these regulations extend beyond partnership taxation.

b. Reg. § 1.752-6

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

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

For "Son-of-BOSS" and substantially similar transactions (Notice 2000-44, 2000-2 C.B. 255), the only exception is the one for a transfer of the trade or business associated with the liability. The section 358(h) exception for a transfer of substantially all the assets associated with the liability does not apply. Otherwise both of the exceptions in section 358(h)(2) (without Reg. § 1.358-5, discussed in part X.A.3., above) apply – transfers of a trade or business associated with the liability or transfers of substantially all of the assets associated with the liability assumed.

The temporary regulations are said to be effective retroactively from the date of enactment of section 358(h) (October 18, 1999) but not after the date of publication (June 24, 2003). The preamble to T.D. 9062 explains the retroactive treatment by referring to a non-Code provision in the statute enacting section 358(h). Consolidated Appropriations Act of 2001, Pub. L. No. 106-554 (106th Cong. 2d Sess. 2000), § 309(c). This provision directs Treasury to prescribe section 358(h)-like rules for partnership transactions. This unusual cut-off of effectiveness on the date of publication is due to the fact that a more elaborate regime in the regulations (described in part X.A.4.c., below) took effect on that day.

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

Reg. § 1.752-6 has had a mixed reception from the courts in "Son-of BOSS" transaction cases, although, with one exception, the outcomes of these cases have favored the government. In *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), the court applied Reg. § 1.752-6 against taxpayer retroactively, in accordance with its terms, and the loss created in a "Son-of-BOSS" transaction was disallowed. In *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), however, the district court held that Reg. § 1.752-6 could not be applied retroactively against the taxpayer, because the taxpayer was justified in relying on prior law. Nevertheless, the court disallowed the claimed loss, because the transactions lacked economic substance. The court of appeals affirmed on these grounds but declined to take up the retroactivity issue. (The court of appeals also reversed the district court's decision that would have allowed the taxpayer to deduct related interest and expenses.) In *Sala v. United States*, 101 AFTR 2d 2008-1843 (D. Colo. 2008), the tax benefits of a Son-of BOSS transaction were allowed as having economic substance; the court rejected *Cemco* and held that Reg. § 1.752-6 could not be applied retroactively. In *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), the loss created in a short sale Son-of BOSS transaction was disallowed, because the partnership's short sale obligation was treated as "liability" under section 752 under revenue rulings in effect before Reg. § 1.752-6, and that regulation was held inapplicable. *See also 7050 Ltd. v. Commissioner*, T.C. Memo. 2008-112, in which the loss created by a Son-of BOSS transaction was disallowed, because the options transferred to the partnership had expired before the transfer, and because the distribution of the options by the partnership to the partner did not fully liquidate partner's interest. For a comprehensive review of the Son-of-BOSS cases decided as of June 2009 (ten cases in all), *see* M. Jackel & R. Crnkovich, "Son-of-BOSS Revisited," 123 Tax Notes 1481 (June 22, 2009).

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

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

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

- "Liabilities" are defined as obligations that already have been (or never will be) taken into account in the tax system – obligations that have given rise to basis in an obligor's asset or in an immediate deduction and obligations that are neither deductible nor chargeable to capital account. Reg. § 1.752-1(a)(4)(i). The regulations do not change the treatment of these liabilities, except to define the category. These liabilities continue to be taken into account under normal tax accounting principles, and liabilities of a partnership are allocated among partners and affect their basis in their partnership interests under prior section 752 principles.

- All other obligations are referred to as "§ 1.752-7 liabilities." These are generally unpaid and unfixed contingent obligations, including environmental, pension, contractual and short sale obligations and the like. These are obligations that have not yet been taken into account in the tax system, but will be taken into account in the future.

With these definitions (and several others) setting the stage, the regulations establish a new regime for dealing with a partner's § 1.752-7 liabilities that a partnership or another partner assumes. Reg. § 1.752-7. One approach could have been simply to require a reduction in a partner's basis in its partnership interest any time a § 1.752-7 liability is assumed by the partnership and is allocated to another partner. But this approach would have led to two problems:

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

Instead, the regulations prevent double deductions, accelerated deductions and changes in location of the tax attributes of § 1.752-7 liabilities, all without duplicated basis reductions, by identifying the liability with the partner who transferred it to the partnership. The first principle of the regulations is that the deduction or asset basis attributable to a § 1.752-7 liability remains with the partner that incurred the § 1.752-7 liability (referred to as the "§ 1.752-7 liability partner"), under section 704(c) principles. Reg. § 1.752-7(c).

- Thus, when a partnership satisfies a § 1.752-7 liability, the resulting deduction or asset basis increase is allocated to the § 1.752-7 liability partner who incurred the liability, to the extent of his or her built-in loss at the time of the assumption of the liability. This reduction in liability allocated to the § 1.752-7 liability partner results in a reduction in its basis in its partnership interest. (The deduction or inside asset basis increase adjusts partnership interest basis separately.)
- The section 704(c) regulations are also amended to treat any partnership property whose basis is increased when a § 1.752-7 liability is paid "as section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized." Reg. § 1.704-3(a)(8)(iv).
- This rule bears similarity to the treatment of assumed contingent liabilities in asset sales. In an asset sale, upon satisfaction of the liability by the Acquiror, the Target that incurred the liability is deemed to receive additional amount realized on the sale with an offsetting deduction. The Acquiror treats the payment in satisfaction of the liability as additional purchase price for the purchased assets, not as a deduction. *See* part IV.D., above. But, unlike the asset sale situation, the amount of the § 1.752-7 liability that is allocated specially to the § 1.752-7 liability partner is limited to the amount necessary to eliminate the partner's built-in loss (if any) in his or her partnership interest as of the time the liability was assumed.

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

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

One of the section 358(h) exceptions – the one relating to transfers of active business – applies in partnership situations under the regulations. There is also a *de minimis* exception for situations where the built-in loss on all § 1.752-7 liabilities assumed by the partnership is less than 10% of the partnership's gross assets, up to $1 million. As with transfers to corporations, (*see* part X.A.3., above) a transfer to a partnership of substantially all the assets related to a § 1.752-7 liability assumed by the partnership does not prevent the liability from being subject to the regime of Reg. § 1.752-7.

The regulations also include special rules dealing with all "liabilities" (defined for this purpose by reference to section 358(h) – a definition similar to the definition of "obligation" in the section 752 regulations) assumed by a partnership and then assumed from the partnership by a corporation. Reg. § 1.358-7.

The regulations became effective on the date the proposed regulations were published (June 24, 2003). In other words, even past transactions are affected, but this retroactivity feature has met with resistance from the courts. *See* part X.A.4.b., above.

The preamble to the proposed regulations pointed out that concepts in the proposed regulations could find their way into corporate tax rules. Specifically, the definition of "liability" may find application for subchapter C purposes. 68 Fed. Reg. 37,434 at 37,436 (June 24, 2003). *But see* part X.B.1., below, dealing with a proposed requirement that Target in a reorganization transfer "net value".

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

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

In March 2005, regulations were proposed to make clear that, for a transaction to qualify as a tax-free reorganization, there must be a transfer of "net value" by Target to Acquiror. Notice of Proposed Rulemaking, REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 FR 11903 (Mar. 10, 2005). In other words, the fair market value of the assets transferred must be greater than the liabilities assumed in the transaction. For this purpose, contingent liabilities are included in Target's liabilities. Thus, Target's contingent liabilities could prevent an acquisition from qualifying as a reorganization. But the method of determining the amount of liabilities is not specified. The preamble suggests several ways in which the amount of liabilities might be determined. These methods, include (a) the "value" of each liability (the amount a third party would have to be compensated to assume the liability) and (b) the maximum amount of the liability if there is a more-than 50% probability of payment (*Merkel v. Commissioner*, 109 T.C. 463 (1997)), and (c) disregarding the excess of a nonrecourse liability over the fair market value of the property securing it.

2. Identity of the Acquiring Corporation

Contingent liabilities are like any other liabilities for purposes of determining whether their assumption is taxable "boot." Generally, only the "acquiring corporation" may assume liabilities tax-free. This term is defined in Reg. § 1.381(a)-1(b)(2). So the parties must be careful in structuring transactions to be sure the correct corporation "assumes" the liability, within the meaning of section 357(d). *See* Rev. Rul. 70-107, 1970-1 C.B. 78, Rev. Rul. 70-224, 1970-1 C.B. 79, and Rev. Rul. 73-257, 1973-2 C.B. 189 (in triangular acquisition, Parent may assume Target liabilities if acquisition is a merger, but not otherwise).

3. Cause-to-Direct Acquisitions

a. General

In Rev. Rul. 64-73, 1964-1 C.B. 142, IRS allowed the acquiring corporation to cause Target assets to be transferred directly to a lower-tier subsidiary. IRS evidently has taken the position that, in such a transaction, the Target liabilities may not be assumed directly from Target by the subsidiary.

b. Disregarded Entities

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

C. Deductions to Acquiror and Related Matters

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

The treatment of contingent liabilities in tax-free acquisitive reorganizations is codified in section 381(c)(16) and the regulations. Reg. §§ 1.381(c)(4)-1(a)(1)(ii), 1.381(c)(16)-1(a).

Generally, Acquiror steps into Target's shoes and may deduct otherwise-deductible liability items assumed from Target. Nondeductible liability items assumed from Target are not deductible. *W. D. Haden Co. v. Commissioner*, 165 F.2d 588 (5th Cir. 1948) (tax liability assumed in tax-free merger capitalized when paid; post-merger interest deductible); Rev. Rul. 73-146, 1973-1 C.B. 61. If the liability was reflected in determining the amount of stock issued in the reorganization, the general rule in section 381(c)(4) applies, and Acquiror steps into Target's method of accounting. The results appear to be the same either way.

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

Contingent liabilities of Target that are assumed and paid by Acquiror but indemnified by former Target shareholders could be treated as never paid by Acquiror (especially if the indemnity involves return of stock issued in the reorganization). The case law, however, supports treating the indemnity payment as contributed to Target's capital by the former Target shareholders. As a result, a deduction would be allowed to Acquiror.

a. Treatment of Acquiror and Target

In *VCA Corp. v. United States*, 77-2 USTC ¶ 9736, 40 AFTR 2d ¶ 77-5429, *unpublished opinion*, 566 F.2d 1192 (Ct. Cl. 1977), the court allowed Acquiror to deduct certain Target expenses, even though indemnified by the former Target shareholders. This seems to be the right answer, since Acquiror, as Target's successor, ought to have the deduction. IRS has adopted the view of the *VCA* court. AOD 1981-115. In this case, Acquiror realizes no taxable income from the reimbursement. Rev. Rul. 83-73, 1983-1 C.B. 84, *clarifying* Rev. Rul. 58-374, 1958-2 C.B. 396. GCM 38977 (Apr. 8, 1982) explains this result as following from the treatment of the indemnity payment as a contribution to Target's capital, occurring immediately before the merger.

b. Treatment of Former Target Shareholders

Treating the indemnity payment as a capital contribution means that the former Target shareholders are not entitled to deduct the payment. Instead, the payment is treated as an increase in their basis in their Target stock before the acquisition. The result is akin to a double deduction: Target gets the ordinary deduction for the item itself, as described in parts V.D.2. (for a taxable stock sale) and X.C.2.a. (for a reorganization), above, and the Target shareholders get a stepped-up basis in the Acquiror stock as a result of a deemed contribution to Target's capital immediately before the reorganization. This increased stock basis would be reflected in the basis in the Acquiror stock received in the reorganization. *Kaufmann v. Commissioner*, 10 TCM (CCH) 790, PH TCM ¶ 51250 (1951); *McGlothlin Estate v. Commissioner*, 370 F.2d 729 (5th Cir. 1967), *aff'g* 44 T.C. 611 (1965); *Edwards v. United States*, 70-1 USTC ¶¶ 9188, 12,654, 25 AFTR 2d 526 (W.D. PA. 1970); *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44.

3. Section 351 Exchanges – General

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

Section 381 does not apply to transfers of assets or businesses under section 351. Without section 381, the corporate transferee could be subject to case law treating liability assumptions as part of the cost of the property and so capitalized when paid (not deducted by the transferee and perhaps not the transferor either). *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946). *See also F. Tinker & Sons Co. v. Commissioner*, 1 B.T.A. 799 (1925); *Caldwell & Company v. Commissioner*, 26 B.T.A. 790 (1932), *aff'd per curiam*, 65 F.2d 1012 (2d Cir.

1933); *Automatic Sprinkler Company of America v. Commissioner*, 27 B.T.A. 160 (1932); *F. S. Stimson Corp. v. Commissioner*, 43 B.T.A. 303 (1938); *Brown Fence & Wire Co. v. Commissioner*, 46 B.T.A. 344 (1942); *Portland Gasoline Company v. Commissioner*, 181 F.2d 538 (5th Cir. 1950). If the transferor did not recognize gain in the transfer (as would be the case for an assumed liability, unless section 357(b) or section 357(c) applied), the transferee would get no asset basis for the payment either.

b. Rev. Rul. 95-74, 1995-2 C.B. 36

Here, IRS ruled that contingent environmental liabilities of a transferor assumed in a section 351 transfer of a business resulted in deductions to the transferee as the payments were made. IRS believes this *ad hoc* "step-in-the-shoes" favorable treatment is limited to situations where the assets transferred and the liabilities assumed involved a transfer of a full business, and where there was a business purpose for the transfer. The IRS concern was with transfers of contingent liabilities to a corporation and a sale of the stock of the corporation, with a resulting duplicated loss. FSA 199905008 (Oct. 29, 1998), *reconsidered by* FSA 199929015 (Apr. 20, 1999); TAM 200006014 (Oct. 22, 1999). More recently, IRS issued Notice 2001-17 as published guidance on this problem, and followed up with FSA 200122022 (June 1, 2001), FSA 200121013 (May 25, 2001), FSA 200134008 (Aug. 24, 2001) and CCA 200117039 (Apr. 27, 2001). In 2001, this treatment was definitively eliminated by enactment of new section 358(h). *See* part X.A.3., above.

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

a. General

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

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

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

- No stock basis reduction because no "liability" (sections 357(c)(3) and 358(d)) and/or no "assumption" (section 357(d)).

- Loss disallowance on the stock under section 358(h).
- Stock basis reduction at the time of the transfer.
- Stock basis reduction when all-events and economic performance tests are met (parity with transferor treatment).
- Possible double counting of stock basis reduction in consolidated return has been eliminated by Reg. § 1.1502-80(d) (generally turning off section 357(c) within a consolidated group).

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

If the transferor gets no tax benefit (no deduction or step-up in asset or stock basis) from its incurring of the contingent liability or from the transferee's payment of the liability, then the transferor's basis in the stock of the transferee should not be reduced by the transferee's assumption of the liability.

On the other hand, if the transferor does get tax benefit from any of these events, the transferor's basis in the stock of the transferee should be reduced to reflect the fact that it got a tax benefit at no cost.

c. Implementation

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

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

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

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

a. Assumption of Contingent Liabilities by Spun-Off Subsidiary

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

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

Under section 357(d), an "assumption" of the liabilities by Controlled for tax purposes can be effected either by a legal assumption (with no indemnity from Distributing) or by an indemnity to Distributing. In other words, the concept of an "assumption" is the same in a divisive type-D reorganization as in a section 351 exchange. *See* part X.A., above.

Similarly, Rev. Rul. 95-74 should apply to a divisive type-D reorganization in the same manner as to a section 351 exchange. In Rev. Rul. 95-74, IRS ruled that the transferee corporation in a section 351 exchange may deduct payments of contingent liabilities incurred by the transferor, so long as the business or assets that generated the deduction are also transferred. *See* part X.C.3.b., above. CCA 201023056 (Sept. 22, 2009) adopts the view that, if Controlled assumes a contingent liability in a divisive type-D reorganization, it may deduct its payment of the liability under the same theory as in Rev. Rul. 95-74, but that relief under section 134, is not available.

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

b. Stock Options and Restricted Stock

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

CONTINGENT CONSIDERATION AND CONTINGENT LIABILITIES IN ACQUISITIONS

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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))[2]
Sections 453(f)(8), (j)(2) (treatment of contingent payments in installment sales)
Section 468B(g) (regulation authority on taxation of income earned on amounts in escrow)
Section 483(d)(4) (exception from OID and imputed interest requirements for transfers of patents)
Section 1060(a) (allocation of consideration in sales of trade or business assets, for purposes of seller's gain and loss recognition and buyer's basis)
Section 1234A (dictates "sale or exchange" treatment for cancellation, lapse, expiration or other termination of a right or obligation with respect to certain property which is (or would be upon acquisition) a capital asset in the hands of the taxpayer)
Section 1271(a) (redemption by a borrower of debt instrument is a "sale or exchange")
Section 1253(d) (current deduction for certain payments for franchises, trademarks and trade names)

[2] 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 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)(*1*) (payments for right to use know-how and information base (other than customer base) not chargeable to capital account, if all substantial rights, or undivided interest, not transferred under 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)

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)

Inja 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)

Rhodes Est. v. Commissioner, 61 T.C. 140 (1973) (sale of right to declared but unpaid dividends yields ordinary income)

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

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

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

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) (purchases 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)
Brisbee-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)
Bellamy v. Commissioner, 43 T.C. 487 (1965) (lack of taxpayer investment held to suggest ordinary income treatment)
Lozoff v. U.S., 266 F. Supp. 966 (E.D. Wis. 1967) (sale of right to act as purchasing agent yields ordinary income)
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)
Billy Rose's Diamond Horseshoe, Inc. v. Commissioner, 448 F.2d 549 (2d Cir. 1971) (release of contract right to repair leased premises isn't a sale)
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)
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)
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)
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*)
Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975) (open transaction treatment denied to seller on real estate sale; seller must report income in year of sale if contract has fair market value; contract was salable even though seller could only get about 58% of face value)
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)
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)
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 (2nd 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 Investerings*)

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

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. Fletcher, 103 AFTR 2d 2009-1674, (7th Cir. 2009), *aff'g* 101 AFTR 2d 2008-588 (N.D. Ill. 2008) (same transaction and same result as in *Culp*, but 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)

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)

Revenue Rulings and Notices

Rev. Rul. 68-13, 1968-1 C.B. 195 (installment obligation may be allocated to certain assets in a larger sale; *see Monaghan*)

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 (escrow deposits for accrual method contractor not income if release of funds from escrow conditioned on performance of contract, but income if contractor has power of investment)

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)

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)

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)

Commentary

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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

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

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.")
Cooledge 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; revoked 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)*

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; 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;

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* 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).

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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M. Kovey, “Insurers Want Purchase Allocation Regs Clarified,” 2000 TNT 145-16 (July 27, 2000)
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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)

LAFA 20055202F Sept. 13, 2005) (In sale of stock, Target purports to distribute to Seller the right to specified percentage of anti-dumping subsidy payments received by Target after closing; 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)

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 successor corporation of liability on guarantee of corporate predecessor *held* 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)

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.

ABA Section of Taxation, "Comments Regarding Liability Assumption Provisions in IRS Restructuring Bill," 1998 TNT 127-10

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

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)

D.C. Bar Ass'n Section of Tax'n, Corp. Tax Comm., "Comments on Advanced Notice of Proposed Rulemaking Concerning Assumption of Liabilities," (May 19, 2003) 2003 TNT 229-20

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)

M. Jackel & R. Crnkovich, "Son-of BOSS Revisited," 123 Tax Notes 1481 (June 22, 2009)

R. Lipton, "No 'Bliss' in *New Phoenix Sunrise*—Tax Court Rejects and Penalizes a Tax Shelter Transaction," 111 J. Taxation 21 (July 2009)

M. Jackel, "Dawn of a New Era: Congress Codifies Economic Substance," 127 Tax Notes 289 (Apr. 19, 2010)