NEW YORK STATE BAR ASSOCIATION
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The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Steven Miller
Acting Commissioner
Internal Revenue Service
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Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: Report on Tax Treatment of "Deferred Revenue" Assumptions by the Buyer in Taxable Asset Acquisitions

Dear Messrs. Mazur, Miller and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report requests guidance on an issue of longstanding uncertainty: the proper tax treatment by the buyer of the assumption of a deferred revenue liability of the seller in a taxable asset acquisition of a business.

By way of background, deferred revenue generally arises when a customer of the seller has made a prepayment under a contract to provide goods or services in the future. Under the accrual method of accounting, payments of this kind are generally includible in income by the seller, subject to certain exceptions. Under current law, the tax consequences to the buyer of assuming these types of liabilities are unclear, both when the seller elects or is otherwise permitted to defer the original prepayment under the Code (*e.g.*, under Section 455) and when the seller is required to report the

prepayment as current income. Based upon limited guidance over several decades, two predominant paradigms have emerged.

Under the first paradigm, the assumption of a deferred revenue liability is treated in the same manner as the assumption of any other contingent liability: the buyer includes the liability in its basis in the acquired assets, but only as it incurs the related expense. Under the second paradigm, the assumption is treated as a separate and distinct transaction: the buyer is treated as having purchased some of the assets from the seller in one transaction and receiving the rest of the assets from the seller as consideration for assuming the deferred revenue liability. In this second transaction, the buyer is effectively treated as "stepping into the shoes" of the seller. The deemed payment to the buyer is either subject to immediate tax or entitled to deferral to the same extent as the original prepayment from the seller's customer. In either case, the buyer would deduct (rather than capitalize) the related expenses.

The attached report argues that whether the liability in question concerns a prepaid obligation or some other contingency, the determination of which of the two paradigms should govern the assumption in a taxable asset acquisition of a business depends upon which of two conflicting tax rules is the proper one: the rule that governs the receipt of advance payments in the ordinary course of business for undertaking a contingent obligation or the rule that governs the assumption of such an obligation in a taxable asset acquisition. Although both transactions are essentially the same, they are subject to very different tax treatment. The reason is that the first rule rejects "accretion to wealth" as the guiding tax principle and the second does not.

In the case of contingent liabilities *other than* deferred revenue, the "no accretion to wealth" rule trumps the advance payment rule even though it would be possible to disaggregate a sale of assets into a series of constructive in-kind payments by the seller to the buyer as separate consideration for assuming each and every contingent liability. In the absence of any policy reason for treating the assumption of a deferred revenue liability in the same transaction any differently, we do not believe that a buyer should be charged with income when it assumes a deferred revenue liability because neither type of assumption results in any accretion of wealth.

For these and other reasons, the report recommends that future guidance adopt the contingent liability paradigm as a single unitary rule governing all assumptions of deferred revenue liabilities.

We appreciate your consideration of our recommendations.

Respectfully submitted,

Andrew W. Needham
Chair

Enclosures

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