# NEW YORK STATE BAR ASSOCIATION TAX SECTION

## REPORT ON

## TREATMENT OF "DEFERRED REVENUE" BY THE BUYER

## IN TAXABLE ASSET ACQUISITIONS

**January 7, 2013**

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Report No. 1281

**New York State Bar Association Tax Section**

**Report on Treatment of "Deferred Revenue" by the Buyer in Taxable Asset Acquisitions**

## I. Introduction

This report[1] recommends that the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issue guidance on an issue of longstanding uncertainty: the tax consequences to the buyer of assuming a deferred revenue liability in a taxable asset acquisition of a business. Although the recommendations in this report are limited to the tax treatment of the buyer, the report discusses the tax treatment of both the buyer and the seller in these transactions.

Deferred revenue is a type of liability. It generally arises in the ordinary course of business when a customer makes a prepayment to a vendor under a contract to provide goods or services. Under the accrual method of accounting, payments of this kind are generally includible in income by the vendor upon receipt, even though the value of the payment is offset by the vendor's obligation to provide the goods or services, the costs of which may be higher or lower.

For book purposes, the initial accounting treatment of a prepayment is the same as the initial accounting treatment of a loan: the vendor debits the asset side of the balance sheet by the amount of the prepayment and credits the liability side of the balance sheet by an equal amount of "deferred revenue".[2] When the vendor later provides the goods or services, it debits (*i.e.,*

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[1] The principal author of this report is Lee E. Allison. Significant contributions were made by Stephen P. Foley, Adam D. Greenwood, Stephen B. Land, Andrew W. Needham and Michael L. Schler. Helpful comments were received from Kathleen L. Ferrell, Lawrence M. Garrett, Marcy G. Geller, Robert H. Scarborough, David H. Schnabel, Richard L. Reinhold, David R. Sicular, Eric B. Sloan and Philip Wagman. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Although deferred revenue usually involves a prepayment of cash, it may involve a current receivable equal to the full amount due from the customer. In such a case, the vendor would debit accounts receivable rather than cash.

reduces) the deferred revenue liability account on the balance sheet and reports a corresponding amount of revenue on the income statement. The amount reported as revenue on the income statement reflects the portion of the prepayment "earned" by the vendor during the period in question. As discussed later in this report, the tax treatment of certain limited categories of advance payments (*e.g.*, prepaid subscription fees) is similar to their book treatment.

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 able to defer the original prepayment under the Code[3] and when the seller is required to report the prepayment as current income. Based upon limited (and often conflicting) guidance over several decades, two dominant paradigms have emerged.[4]

Under the first paradigm (the "Assumption Approach"), the assumption of a deferred revenue liability is treated in the same manner as the assumption of any other contingent liability:[5] The seller includes the liability in its "amount realized" at its current value for

[3] Unless indicated otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

[4] Exhibit A of this report provides detailed examples of the tax consequences to the buyer of both of these approaches.

[5] Although the tax treatment of the assumption of a contingent liability in an asset acquisition is relatively clear, some uncertainly remains even to this day. Although a detailed discussion of the treatment of contingent liabilities in asset acquisitions is beyond the scope of this report, the treatment described in this report reflects what we believe to be current law. For a fuller discussion of the law in this area, *see* Jodi J. Schwartz, *It Doesn't Get Easier Than This? Liabilities and Asset Sales Reexamined*, Tax Forum No. 641 (Oct. 1, 2012); Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶304 (2012); Glenn R. Carrington, *Tax Accounting in Mergers and Acquisitions*, ¶401-406 (2010); Robert Willens, *Assumed Liabilities vs. Postacquisition Obligations*, 117 Tax Notes 53 (Oct. 1, 2007); Daniel Halperin, *Assumption of Contingent Liabilities on Sale of a Business*, 2 Fla. Tax Rev. 673 (1996); Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 Tax Law. 765 (1991); New York State Bar Association Tax Section, *Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions* (Nov. 1, 1990), *reprinted in* 49 Tax Notes 883 (Oct. 16, 1990) (the "1990 NYSBA Report"); Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 Tax L. Rev. 605 (1988).

purposes of computing its gain or loss on the date of sale[6] and then treats the sale as a closed transaction.[7] Depending on the type of liability, the seller usually claims an offsetting deduction or increase in basis.[8] The buyer includes the liability in its basis in the acquired assets,[9] but only as and when the liability becomes fixed or is otherwise properly taken into account for tax purposes.[10] The general rationale for such treatment is that "the payment of a liability by a subsequent purchaser is not the discharge of a burden, which the law has placed upon him, but is actually as well as theoretically, a payment of the purchase price."[11] As such, the treatment of any future payments as nondeductible capital expenditures has been followed even when the contingent liability is settled for more than its expected value at the time of the sale.[12]

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[6] *See generally* Section 1001; Treas. Reg. § 1.1001-2(a)(1).

[7] *Cf.* Treas. Reg. § 1.1001-1(g)(2)(ii) ("Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable"); Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (open transaction method may be used "only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained"); Treas. Reg. § 1.338-4(d)(1) ("In order to be taken into account in [aggregate deemed sale price ("ADSP")], a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. *See* § 1.1001-2(a).").

[8] *See*, *e.g*., *Commercial Security Bank v. Comm'r*, 77 T.C. 145 (1981) *acq.* 1986-2 C.B. 1; *James M. Pierce Corp. v. Comm'r*, 326 F.2d 67 (8th Cir. 1964); Treas. Reg. § 1.461-4(d)(5)(i); Treas. Reg. § 1.461-4(g)(1)(ii)(C); *see also* Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶304.01 (2012).

[9] *But see Nahey v. Comm'r*, 196 F.3d 866 (7th Cir. 1999) ("In some of the cases that Nahey cites, the court may have misclassified an expenditure (he points chiefly to *Pacific Transport Company v. Comm'r*, 483 F.2d 209 (9th Cir.1973) (per curiam)), and treated an ordinary expense as a capital one. If so (which we needn't decide), those cases are incorrect").

[10] *See*, *e.g*., Rev. Rul. 55-675, 1955-2 C.B. 567; *David R. Webb Co., Inc. v. Comm'r, 708 F.2d 1254, 1256* (7th Cir. 1983) (there is a "well-settled general rule that when an obligation is assumed in connection with the purchase of capital assets, payments satisfying the obligation are non-deductible capital expenditures"); *Pacific Transport Company v. Comm'r*, 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974); *Holdcroft Transportation Co. v. Comm'r*, 153 F.2d 323 (8th Cir. 1946). *See also* Treas. Reg. § 1.338-5(e)(1) ("In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets from an unrelated person for consideration that included discharge of the liabilities of that unrelated person.").

[11] *Pacific Transport Company v. Comm'r*, 483 F.2d 209, at 214 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974).

[12] In *Illinois Tool Works Inc. v. Comm'r*, the Seventh Circuit considered the proper treatment of the payment of a contingent liability by a taxpayer that had assumed the liability in connection with an acquisition of assets. The ultimate amount of the liability exceeded what the parties had anticipated, though the parties were aware of the

The rationale for this treatment is that deferred revenue is a form of liability, namely the liability to provide the contracted for goods or services. The liability is contingent rather than fixed.[13] A deferred revenue liability is contingent in at least two respects. First, the cost of providing the goods or services under the customer contract is unknown – the actual cost will almost invariably differ from the amount reflected as a liability at closing. Second, if the vendor fails to provide the goods or services, it will usually be required to refund all or a portion of the prepayment to its customer.

Accordingly, a buyer would not recognize income on the date of sale under this paradigm when it assumes a deferred revenue liability for the same reason it would not recognize income when it assumes any other type of fixed or contingent liability: like a loan, the assumption of a deferred revenue liability is not an accretion to wealth. In addition, the buyer would be required to capitalize (rather than deduct) the actual costs of fulfilling the underlying contracts whether or not they exceed the amount reflected as a deferred revenue liability on the date of sale.[14]

Under the second paradigm (the "Fragmentation Approach"),[15] the assumption of the deferred revenue liability is treated as a separate and distinct transaction. The buyer is therefore treated as having purchased some of the assets in one transaction and as having received the rest of the assets in another transaction in consideration for assuming the deferred revenue liability.

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existence of the liability at the time of acquisition. The court held that the buyer was required to capitalize the entire liability into the basis of the acquired assets. 355 F.3d 997 (7th Cir. 2004). In *Pacific Transport Company v. Comm'r*, the Ninth Circuit reached a similar result even though neither party was aware of the contingent liability at the time of the acquisition. 483 F.2d 209 (9th Cir. 1973).

[13] *See* 1990 NYSBA Report (citing *Pierce* (discussed *infra)* as authority for proposition that buyer does not recognize net income when the buyer assumes a contingent liability).

[14] For the tax treatment of "excess" fulfillment costs, *see generally Illinois Tool Works Inc. v. Comm'r*, 355 F.3d 997 (6th Cir. 2004), and *Pacific Transport Company v. Comm'r,* 483 F.2d 209 (9th Cir. 1973).

[15] *See* GCM 34418 (2/3/1971) (using the word "fragmentation" when analyzing a taxable asset acquisition in which the buyer assumes a deferred revenue liability).

In this second paradigm, the buyer is effectively treated as "stepping into the shoes" of the seller, with the buyer becoming the vendor to the third party customer. This 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 customer. In either case, the buyer would deduct (rather than capitalize) the actual costs of fulfillment whether or not they exceed the deferred revenue liability.

## II. Summary of Recommendations

This report makes the following recommendations:

1. Treasury and the IRS should issue guidance adopting the Assumption Approach, treating the assumption of a deferred revenue liability in a taxable asset acquisition of a business in the same manner as the assumption of other types of contingent liabilities. As such, the assumption of a deferred revenue liability would not give rise to immediate income. Consistent with such treatment, the buyer would also be required to capitalize the costs of fulfillment associated with providing the relevant goods or services.

2. Such treatment should apply without regard to whether the seller was permitted or chose to defer the original prepayment from its customers under Section 455 or any other provision of the Code and without regard to whether the purchase and sale agreement or other documents establish that the buyer either reduced the cash purchase price by a stated amount to reflect the assumption or provide for a separate "payment" of assets as consideration for the assumption.[16] We do not believe such formalities should govern the buyer's tax treatment of these liabilities.[17] We also believe that a single rule governing all asset acquisitions will reduce the apparent electivity otherwise available to buyers under current law.

3. Treasury and the IRS should reject the Fragmentation Approach, both as a single rule governing all asset acquisitions and as a special rule governing only certain asset acquisitions. The Fragmentation Approach treats the buyer as having "stepped into the shoes" of the seller and, by extension, the rules governing the treatment of advance payments from customers.

[16] If the seller was not permitted to defer the original prepayment, the contractual obligation is not a deferred revenue liability for tax purposes. In this report, we nevertheless refer to these contractual obligations as deferred revenue liabilities.

[17] This report does not address the special tax accounting rules governing long-term contracts under Section 460 or the special rules governing "ceding" commissions in certain insurance and reinsurance transactions in light of the substantial amount of guidance under the Code and Treasury Regulations addressing such transactions.

We do not believe this characterization of the assumption is appropriate in the context of a taxable asset acquisition of a business.

4. If Treasury and the IRS nevertheless determine that the Fragmentation Approach is appropriate in the case of certain asset acquisitions, we recommend that future guidance establish a bright-line test defining when and under what circumstances it applies. Any such guidance should also address how taxpayers should calculate and report the associated *Pierce* payment (as defined below).[18]

## III. Summary of Current Law and Relevant Authorities

The proper tax treatment of the assumption of a deferred revenue liability by a buyer in a taxable asset acquisition is not a new issue. As described below, although Treasury, the IRS and the courts have considered this question in the past, no clear consensus has emerged. This section of the report begins with a very brief overview of the general rules governing the treatment of advance payments received from customers in the ordinary course of business. It then discusses the authorities governing the assumption of these types of liabilities in an asset acquisition, addressing both the tax treatment of the assumption itself and the tax treatment of subsequent costs incurred by the buyer to satisfy the assumed liability.

### A. <u>The Tax Treatment of Advance Payments from Customers</u>.

Deferred revenue commonly arises in the ordinary course of business of many vendors, including vendors in the newspaper or magazine business (prepaid subscriptions), vendors in the insurance business (prepaid insurance premiums), and vendors in any other business that enters into prepaid contracts with customers. For this reason, it is not unusual for a buyer to assume contractual liabilities of this kind in a taxable asset acquisition.

For financial reporting purposes, a vendor generally recognizes income only when it is earned, regardless of the date of payment. In general, therefore, a vendor will not report a

[18] As discussed below in Section III.B.1, a *Pierce* payment is a payment (actual or deemed) from the seller to the buyer in consideration for the buyer's assumption of the seller's deferred revenue liability.

prepayment from a customer pursuant to a contract to provide goods as services for more than one year as income until the vendor actually provides the goods or services. Until then, the prepayment remains a liability on the balance sheet. For book purposes, therefore, the initial receipt of an advance payment is not recognized as income because it does not represent any accretion to wealth.

For federal income tax purposes, an accrual-basis taxpayer generally recognizes income when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[19] Ordinarily, a taxpayer's right to income is treated as "fixed" for this purpose when the taxpayer either performs the services or is entitled to payment. In general, therefore, accrual method taxpayers recognize income when it is paid, due or earned, whichever occurs first.[20]

Both the Code and various IRS pronouncements provided limited relief from this rule in the case of certain types of advance payments:

- *Periodical Subscriptions.* Section 455 provides generally that a taxpayer who receives certain prepaid subscription amounts for newspaper, magazine or other qualifying periodicals is not required to recognize such prepayments until the taxable year the taxpayer has the obligation to furnish the newspaper, magazine or other periodical to which the prepayment relates.

- *Membership Dues*. Section 456 provides for limited deferral to membership organizations with respect to prepaid dues.

- *Next Year Performance*. To at least *partially* reconcile the tax and financial accounting treatment of payments received in one taxable year for goods or services to be provided or performed over more than one taxable year, Revenue Procedure 2004-34 generally permits taxpayers to defer the portion of any advance payment not attributable to the taxable year of receipt to the succeeding

[19] Section 451; Treas. Reg. § 1.451-1(a).

[20] *See, e.g.,* Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 74-607, 1974-2 C.B. 149, obsoleted by Rev. Proc. 94-29, 1994-1 C.B. 616. *See also* Treas. Reg. § 1.451-5 (treatment of certain advance payments).

taxable year, but only to the extent the payments are not recognized as revenue for financial reporting purposes in the taxable year of receipt.

- *Certain Advance Payments*. Accrual method taxpayers may defer the recognition of income upon the receipt of advance payments for certain types of goods or services until the taxable year in which the amounts are properly accruable under the taxpayer's method of tax accounting, provided such method results in including the advance payments in gross income no later than the time such amounts are included in gross receipts for financial accounting purposes.[21]

For many advance payments, therefore, the book and tax treatment widely diverge. Under the accrual method of accounting, most advance payments are includible in income upon receipt even though the taxpayer has not yet provided the goods or services and has therefore not earned the right to the income.

B. The Tax Treatment of the Assumption of a Deferred Revenue Liability.

As discussed above, the proper tax treatment by the buyer of the assumption of a deferred revenue liability in a taxable asset acquisition is unclear. Although the two paradigms described above produce very similar tax consequences to the seller, they produce very different tax consequences to the buyer.[22]

Consider the following example:

> *Example*: in a taxable asset acquisition, buyer acquires seller's business, which consists of $1 million in cash, $1 million of goodwill and a $1 million deferred revenue liability related to certain prepaid contracts between seller and its customers. The $1.2 million purchase price reflects buyer's estimate that it will cost $800,000 to fulfill the seller's obligations under these contracts.

The Assumption Approach would characterize the assumption of a deferred revenue liability in a taxable asset acquisition of a business in the same manner as the assumption of any

[21] Treas. Reg. § 1.451-5.

[22] Exhibit A of this report also provides examples of the tax consequences to the buyer under the Assumption Approach and the Fragmentation Approach.

other contingent liability of the seller. The buyer in this example would therefore recognize no income at closing and would have a $1.2 million tax basis in the acquired assets ($1 million in the cash and $200,000 in the goodwill). During future periods, the buyer would add any costs incurred to satisfy the deferred revenue liability to its tax basis in the acquired goodwill.[23]

The Fragmentation Approach would "fragment" the same transaction into two distinct transactions: (i) a taxable purchase of a portion of the assets by the buyer for a cash purchase price of $1.2 million (taking into account the projected $800,000 cost of fulfilling the prepaid contracts) and (ii) a separate $800,000 payment of the remaining assets from the seller to the buyer for assuming the deferred revenue liability.[24] The buyer would report the $800,000 payment as current income (unless eligible for deferral), claim a $2 million tax basis in the acquired assets and deduct the actual costs of fulfillment in the future.

1. The Fragmentation Approach Authorities.

*James M. Pierce Corporation v. Comm'r*[25] is the leading authority to bifurcate a unitary sale of assets into two separate transactions, the first consisting of a sale of a portion of the assets to the buyer and the second consisting of a separate transfer of the remaining assets to the buyer as consideration for assuming a deferred revenue liability. The issue in dispute in *Pierce* was the proper tax treatment of the seller of the assumption of previously-deferred subscription fees in connection with a taxable sale of the seller's business to a buyer.

The Tax Court held that the seller realized ordinary income equal to the unreported subscription fees at the time of the sale. The Eighth Circuit, however, held that the current

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[23] *See supra* note 10 and accompanying text.

[24] *See James M. Pierce Corporation v. Comm'r,* 326 F.2d 67 (8th Cir. 1964) (discussed below). *See also generally*, *T.F.H. Publications, Inc.*, 72 T.C. 623 (1979), *aff'd per curiam,* 622 F.2d 597 (3d Cir. 1980); GCM 34418 (2/3/1971); TAM 200147032 (11/26/2001).

[25] 326 F.2d 67 (8th Cir. 1969).

income inclusion was "nullified by an offsetting deduction equal to the amount by which the gross sale price . . . was reduced by [*the*] assumption of the subscription liabilities …." Accordingly, the seller in *Pierce* incurred no net tax attributable to the unreported subscription fees. Specifically, the deduction had the effect of increasing the seller's gain because the court segregated the assets deemed to fund the "*Pierce* payment" from the sale of the other assets, leaving fewer assets (and less basis) to offset the amount realized by the seller and thus increasing the seller's gain on the "sale" portion of the transaction. The seller therefore realized the same amount of income as the seller would have realized in the absence of any assumption.[26] Although the taxpayer in *Pierce* was the seller, the court implied that the buyer would recognize income upon receipt of the *Pierce* payment.

Following *Pierce*, the IRS issued Revenue Ruling 68-112[27] and Revenue Ruling 71-450,[28] both of which presented the same issue. In Revenue Ruling 68-112, a taxpayer sold a newspaper business that had elected to report prepaid subscription income on a deferred basis under Section 455. The IRS ruled that the buyer's assumption of this liability gave rise to a deduction to the seller in an amount equal to reduction in the cash purchase price agreed to by the parties. The IRS equated the *Pierce* payment by the seller to the buyer with a direct payment by the seller to its customers to extinguish the assumed liability (which would have been

[26] The same would be true if the assumption of the subscription liabilities had been subject to the rules governing other contingent liabilities. *See supra* notes 7-8 and accompanying text.

[27] 1968-1 C.B. 62.

[28] 1971-2 C.B. 78.

deductible). In Revenue Ruling 71-450, IRS further ruled that the *Pierce* payment in Revenue Ruling 68-112 was includible in gross income of the buyer.[29]

The Chief Counsel's office then issued an AOD[30] concerning the *Pierce* case, recommending that a petition for certiorari not be filed on the basis that *Pierce* and Revenue Ruling 68-112 were consistent so long as the *Pierce* payment reflected the entire amount of the prepaid subscription account not yet includible in income. The Chief Counsel correctly observed that "there is no necessary relationship between [the reserve account balance] and any reduction in the sales price of the assets" because the expected cost to the buyer of fulfilling the prepaid subscription contracts (like other contingent liabilities) may have differed from the amount reflected by the seller as a liability.

Between the issuance of these rulings, the Chief Counsel's office also released a GCM[31] that revealed a longstanding rift between the IRS and the Justice Department on the validity of *Pierce* and Revenue Ruling 68-112. The Justice Department disagreed with the Fragmentation Approach to these transactions, stating that it "would be embarrassing if not futile" to litigate the issue presented in the GCM unless *Pierce* was appealed and Revenue Ruling 68-112 was revoked. It regarded the Fragmentation Approach as inconsistent with the business reality of a single capital transaction, as well as recent cases that had applied the Assumption Approach to liquidation transactions involving the assumption of deferred revenue liabilities.[32] In the

[29] Although the buyer presumably would have been eligible to defer the income under Section 455 (on the theory that the buyer would have been able to do so had it received these amounts directly from the subscribers), this question was not addressed in the ruling.

[30] 1972 AOD Lexis 464.

[31] GCM 34418 (2/3/1971).

[32] For a similar conclusion published after the GCM, see Rev. Rul. 76-520, 1976-2 CB 42 (rejecting Fragmentation Approach as applied to tax treatment parent corporation's receipt of assets subject to deferred revenue obligations of a subsidiary in a liquidation).

alternative, the Justice Department also argued that even if the Fragmentation Approach was correct, it should apply without regard to whether the seller's obligations were expressly assumed in the agreement. Finally, the Justice Department cited the potential for "whipsaw" under this approach, with sellers claiming a deduction for the *Pierce* payments and buyers failing to report the same payments as income.

The IRS nevertheless stood its ground, reiterating its position that the transaction was in substance two separate transactions, one a sale of a portion of the assets and the other a *Pierce* payment of the remaining assets. Although the IRS acknowledged that other authorities had rejected this approach in the non-recognition context, it argued that these transactions were distinguishable, largely on precedents that had applied the step transaction doctrine. Finally, while acknowledging the potential for "whipsaw", the IRS stated that if the purchase and sale agreement between the buyer and the seller reflected a deductible expense to the seller, the government had a "realistic basis" to argue that the buyer realized an equivalent amount of gross income.

Since then, the IRS has issued various rulings and other guidance consistent with the premise that a *Pierce* payment may arise, at least where the deferred revenue liability is taken into account in calculating the purchase price of the assets. For example, in PLR 8612050,[33] a *Pierce* payment arose because the deferred revenue liability was taken into account by the parties in the calculation of the seller's "net book value", which net amount was added to the purchase price to acquire stock of a corporation on which a Section 338 election was to be made.[34]

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[33] 12/23/1985. *See also* PLR 8749076.

[34] The PLR states in part that "[e]ven though the instant transaction is a 'deemed' sale, rather than an 'actual' sale, this distinction does not dictate a result different from *Pierce*, and the holding of that case is applicable."

2. The Assumption Approach Authorities.

In *Comm'r v. Oxford Paper Company,*[35] an affiliate of a taxpayer had previously entered into a lease in perpetuity. When the affiliate assigned the lease to the taxpayer, it transferred $100,000 in cash, $6,000 of stock and $350,000 of other property as consideration. Although the Tax Court held that the property transferred by the affiliate was includible in gross income of the taxpayer, the Second Circuit disagreed. The Second Circuit held that the transaction was properly characterized as a sale of assets by the affiliate to the taxpayer, the sole consideration for which was the assumption of the lease liability.

In Revenue Ruling 55-675, the IRS endorsed the holding in *Oxford Paper*.[36] In the ruling, A and B were parties to similar leases with the same lessor. Because B's operations were unprofitable, B transferred certain supplies, equipment and cash to A in consideration for A's assumption of B's remaining obligations under the lease. The IRS ruled that A did not realize any income in the transaction. It also ruled that the tax basis of the acquired assets would be determined by reference to the amount of the assumed liabilities, but with no basis adjustment until the contingent lease liabilities became fixed and determinable.

The assignment of the leases in *Oxford Paper* and Revenue Ruling 55-675 are analogous to the assumptions of the deferred revenue liabilities in *Pierce* and Revenue Ruling 68-112. All four authorities involved the assumption of an unfavorable contract as consideration in a taxable asset acquisition. From the assuming buyer's perspective, a prepaid contract is an unfavorable contract because it requires the buyer to provide future goods or services to a customer at no cost. In both *Oxford Paper* and Revenue Ruling 55-675, the buyer was *not* treated as receiving

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[35] 194 F.2d 190 (2d. Cir. 1952).

[36] 1955-2 C.B. 657.

any portion of the acquired assets as a separate *Pierce* payment from the assigning lessee for agreeing to the assignment. The assets transferred by the original lessee were instead treated as sold to the buyer in a capital transaction for consideration consisting of the lease assumption.

In a 2000 FSA,[37] a buyer had acquired the assets of a seller in a transaction described in Section 1060. As partial consideration, the buyer assumed the seller's deferred revenue liabilities. Consistent with the Assumption Approach, the IRS determined that (i) the seller had an immediate ordinary income inclusion equal to the deferred revenue liability, and (ii) the buyer was required to include the amount of the deferred revenue liability in the tax basis of the acquired assets. In addition, the IRS concluded that the deferred revenue liability "should also have been included in the amount realized upon the sale." Finally the IRS stated that "[t]he timing of the inclusion of amounts is determined under general principles of tax law." It is not entirely clear if this was intended to mean that the buyer would only capitalize the deferred revenue liability as and when the deferred revenue liabilities become fixed or something else. Significantly, and contrary to earlier rulings,[38] the FSA did not treat the assumption of the deferred revenue liability as a taxable event to the buyer.

Finally, the IRS has followed the Assumption Approach in non-recognition transactions involving the assumption of deferred revenue liabilities. In these cases, the IRS has generally ruled that the transferor realizes ordinary income upon relief from a deferred revenue liability and that the transferor is not entitled to any deduction for the *Pierce* payment. In GCM 37873,[39] for example, a partnership with deferred revenue liabilities attributable to membership

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[37] FSA 200048002 (12/04/2000).

[38] *See* Rev. Rul. 71-450, 197-2 C.B. 78; PLRs 8612050 (12/23/1985), 8749076 (9/11/1987).

[39] 3/5/1979.

subscriptions incorporated in a tax-free transaction under Section 351. In connection with the transaction, the taxpayer paid the transferee corporation to assume the liability. While acknowledging that a deduction would have been allowed if the transaction had been bifurcated into a separate transfer of assets and a separate payment to extinguish a liability, the IRS nevertheless treated the transfer as "a single integrated plan to effect a unified transaction – the incorporation of P's business".[40]

Similarly, in GCM 39413,[41] the taxpayer (a publisher with deferred subscription revenue under Section 455) transferred its operating assets and liabilities to a new corporation in exchange for 100% of the common stock. The ruling declined to follow *Pierce*, distinguishing both *Pierce* and Revenue Ruling 68-112 as involving "outright sales to third parties." Finally, in Revenue Ruling 76-520,[42] the IRS ruled that a parent corporation that received assets of a subsidiary subject to deferred revenue liabilities in a liquidation subject to Section 334(b)(2) of the 1954 Code was required to capitalize (rather than deduct) the costs of fulfillment and realized no income from the assumption, both of which are consistent with the principles of the Assumption Approach.

3. <u>Treatment of Fulfillment Costs.</u>

The proper tax treatment of any actual expenses incurred by the buyer to satisfy a deferred revenue liability should depend upon whether the Assumption or Fragmentation Approach applies to the assumption: if the liability is treated as a contingent liability, the buyer

[40] Similarly, in GCM 34418, the Chief Counsel concluded that the Fragmentation Approach should not extend beyond taxable sales to non-recognition transfers. 2/3/1971.

[41] 3/1/1985.

[42] 1976-2 CB 42.

should be required to capitalize these expenses into the basis of the acquired assets,[43] even if the actual costs incurred exceed the original amount of the deferred revenue liability; if the assumption is instead treated as a separate transaction, the buyer should generally be permitted to deduct the fulfillment costs as incurred if they would otherwise have been deductible to the seller.[44]

## IV. Discussion of Recommendations

### A. Future Guidance Should Adopt Assumption Approach.

We recommend that Treasury and the IRS issue guidance adopting the Assumption Approach, treating the assumption of a deferred revenue liability in a taxable asset acquisition in the same manner as the assumption of other types of contingent liabilities. This approach should govern the transaction without regard to whether the seller elected or was otherwise permitted to defer the original prepayment from its customers under Section 455 or any other provision of the Code and without regard to whether the purchase and sale agreement reflects an identifiable reduction in the cash purchase price in consideration of the assumption or provides for any direct payment from the seller to the buyer for the assumption. Consistent with the general principle that similar transactions should be subject to tax in the same manner, we do not believe that the tax consequences of the assumption of a deferred revenue liability should depend on form. We also believe that a unitary approach to these assumptions will eliminate a great deal of uncertainty for taxpayers, as well as reduce electivity under current law.

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[43] *See, e.g.,* Rev. Rul. 55-675, 1955-2 C.B. 567; Rev. Rul. 76-520, 1976-2 C.B. 42. The first ruling was issued before the *Pierce* decision and the second ruling did not cite *Pierce*.

[44] *See, e.g.,* PLRs 8612050 (12/23/1985), 8749076 (9/11/1987).

1. Deferred Revenue is a Type of Contingent Liability.

As described in this report, deferred revenue is a liability, and in fact a form of contingent liability. It is a liability because the buyer is assuming the cost of the seller's obligation to provide goods or services. The liability is contingent for two reasons. First, the cost of providing the goods or services under the customer contract is unknown. Second, if the vendor fails to provide the goods or services, it may be required to refund the prepayment to its customers.

Deferred revenue has been treated as a contingent liability in a number of authorities involving asset transfers. First, in Revenue Ruling 76-520,[45] a buyer in the publishing business purchased stock of corporation and then liquidated it under Section 334(b)(2) of the 1954 Code, resulting in a tax-free basis step-up under the law in effect at that time. In the liquidation, the buyer legally assumed the obligation to fulfill the prepaid subscription obligations of the acquired corporation. The issue in the ruling was whether the buyer could deduct the costs of fulfillment. The IRS ruled that the buyer was required to capitalize these costs, citing cases involving contingent liability assumptions other than deferred revenue.[46] Second, as described more fully in Section III.B.2., *supra*¸ the IRS has followed the Assumption Approach in other taxable and tax-free assets transfers involving the assumption of deferred revenue liabilities or liabilities similar to deferred revenue liabilities. Third, both IRS guidance and *Pierce* strongly suggest that fragmentation is appropriate even in the case of deferred revenue *only* when the documentation of the sale of assets either reflects the assumption of the liability as separate asset transfer or establishes a readily determinable reduction in the cash purchase price of the other

[45] 1976-2 CB 42.

[46] *Magruder v. Supplee*, 316 U.S. 394 (1942); *Haden Co. v. Comm'r*, 165 F.2d 588 (5th Cir. 1948); *Pacific Transport Company v. Comm'r*, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974).

assets.[47] In the absence of such a finding, the Assumption Approach would presumably govern the assumption.

2. Both Types of Liabilities Have the Same Impact on Purchase Price.

The basic rationale of *Pierce* and its progeny is that the seller made a constructive payment to the buyer, as evidenced by an agreed reduction in the cash purchase price to reflect the assumption of the deferred revenue liability. The construct was thought necessary to establish the seller's right to a deduction even though the deferred revenue liability remained both outstanding and contingent following the sale. In both *Pierce* and Revenue Ruling 68-112, it was noted that if the seller had made the same cash payment directly to its own customers, the payment would have been deductible. Because the seller accepted less cash from the buyer by virtue of the assumption, the seller in substance paid the foregone cash to the buyer to extinguish its liability.[48]

As the Eighth Circuit described it:

> [The Buyer's] assumption of the obligation … is just as much an out-of-pocket payment by the taxpayer as if it had first received the gross amount from [the Buyer] and then repaid [the Buyer] cash equal to the amount of the reserves.[49]

Once a payment is imputed to the buyer, it is but a short leap to conclude that the buyer must have income, which is precisely what the IRS concluded in Revenue Ruling 71-450.[50]

If this is the rationale, however, the same can be said of any other contingent liability assumed in an asset sale that is susceptible of valuation.[51] Nevertheless, no authorities we are

[47] *Pierce*, 326 F.2d at 69.

[48] 1990 NYSBA Report.

[49] 326 F.2d at 72.

[50] Rev. Rul. 71-450, 1971-2 C.B. 78.

aware of have recast a fixed or determinable reduction in the cash purchase price in a taxable asset acquisition of a business to reflect the assumption of a contingent liability as a constructive payment from the seller to the buyer in a separate transaction, resulting in current income and future deductions to the buyer as opposed to future amortizable basis in the acquired assets.[52]

3. Accretion to Wealth and the Accrual Method of Accounting.

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 capital transaction.

If an accrual method taxpayer receives an advance payment in the ordinary course of business as consideration for agreeing to a contingent obligation, it generally must report the payment as income even though it has not yet earned the right to it.[53] If the same taxpayer *assumes* such an obligation in a taxable asset acquisition, it does not have income. Although both transactions are essentially the same, they are subject to very different tax treatment.[54] The reason is that the first rule rejects accretion to wealth as the guiding tax principle and the second does not.

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[51] *See* Jodi J. Schwartz, *It Doesn't Get Easier Than This? Liabilities and Asset Sales Reexamined*, Tax Forum No. 641 (Oct. 1, 2012).

[52] *Id.*

[53] *See* Rev. Rul. 84-31, 1984-1 C.B. 127; *see also Schlude v. Comm'r*, 372 U.S. 128 (1963); *American Automobile Ass'n v. U.S.*, 367 US 687 (1961); *Automobile Club of Michigan v. Comm'r*, 353 US 180 (1957).

[54] Michael L. Schler, *Sale of Assets After Tax Reform, Section 1060, Section 338(h)(10), and More*, 43 Tax. L. Rev. 605, 673 (1988). ("it is impossible to create a result that is consistent with each of two doctrines that are inconsistent with each other").

Suppose, for example, that X receives a guaranty fee in the ordinary course of business. X must report the fee as current income even though the value of the payment is fully offset by the expected cost to X of assuming the contingent payment obligation to the borrower. Now suppose that before the borrower defaults, X sells its business to Y subject to the guaranty. Y is not treated as having received an imputed guarantee fee from X. Y is instead treated as acquiring assets subject to a contingent liability. The reason is that the assumption of X's obligation does not represent an accretion to wealth to Y. Although the same would be true if X had simply paid the same fee to Y in the ordinary course of business, the absence of any accretion to wealth would not prevent Y from recognizing income.

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 the transaction into a series of constructive in-kind payments by the seller to the buyer as separate consideration for assuming each and every contingent liability. For example, a taxpayer who receives a cash payment from a third party for agreeing to make contingent payments to fund a future environmental claim related to a parcel of land has current income under the accrual method of accounting even though it would avoid any income inclusion by assuming the same liability as consideration to acquire the land.

In the absence of any policy reason for treating the assumption of a deferred revenue liability in the same transaction any differently, a buyer should not be charged with income when it assumes a deferred revenue liability.[55] Neither type of assumption results in any accretion of wealth. We note that this "no economic benefit" analysis was among the principal rationales for

[55] In addition, many types of contingent liabilities not normally viewed as related to prepaid income, for example warranty obligations on previously-sold products and guarantees of third party debt, are difficult to distinguish from the type of liabilities at issue in *Pierce*.

our recommendation in the 1990 NYSBA Report that the buyer should not be charged with income under the Fragmentation Approach when it assumes a contingent liability in a taxable asset acquisition.[56]

4. Fragmentation Approach Should not be Elective.

As a policy matter, whether the buyer has immediate income and a future deduction or just contingent additional basis in the acquired assets should not depend on whether a dollar-for-dollar reduction on the cash purchase price can be established from the governing agreements in an acquisition that is in all other aspects identical. Whether or not the reduction in the purchase price to reflect the assumption of the deferred revenue liability is reflected and quantified in the agreement by the parties, the buyer is acquiring the same business and the seller is being relieved of the same liabilities. Similar transactions should be subject to similar tax treatment.

Nevertheless, both IRS guidance and the *Pierce* decision strongly suggest that the Fragmentation Approach only applies under current law when the assumption of the deferred revenue liability is either reflected in a separate agreement or when the precise impact of the deferred revenue liability on the cash purchase price can be established from the purchase and sale agreement.[57] One plausible explanation for imposing such a requirement is that a broader *Pierce* approach to these assumptions would otherwise be unadministrable. We certainly agree that a broader application of the Fragmentation Approach would be very difficult to administer. Unless it is applied more broadly, however, it will invariably produce a number of undesirable consequences.

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[56] 1990 NYSBA Report (stating that "[The Buyer's] receipt of the value of the property which is the deemed premium for assuming the contingent liability is completely offset by the obligation to satisfy the liability" and that "this same logic has long prevented a borrower under a debt instrument from recognizing income.").

[57] *Pierce*, 326 F.2d at 69.

First, if current law in fact requires either an actual payment from the seller to the buyer to assume the deferred revenue liability or other evidence from the purchase and sale agreement that the buyer actually reduced the cash purchase price by a specified amount to reflect the assumption, then current law is effectively elective.

Consider the following example:

> *Example*: S holds a business worth $X dollars, subject to a deferred revenue liability of $20 attributable to certain prepaid customer contracts with a remaining term of two years. Because B estimates that it will incur $30 to fulfill the customer contracts, it pays $X-$30 for the business.
>
> Case 1: although B valued the liability at $30, it never discusses the impact of the liability (or any other contingent liability) on its determination of the cash purchase price.
>
> Case 2: B informs S that it reduced its proposed purchase price by $20 to reflect the assumption of the liability and the parties document the agreement in a manner that clearly reflects a reduction in the cash purchase price of $20.

In Case 1, B will claim $30 of additional basis in the acquired assets as it incurs the $30 of fulfillment costs. In Case 2, B will claim a net deduction of $10 over two years and $20 of additional basis at closing. Although the only difference between the two transactions is how the parties documented them, the buyer in Case 2 derives a larger tax benefit on a present value basis at no incremental cost to the seller.

Second, as the IRS has already acknowledged,[58] the deferred revenue liability on the balance sheet bears no necessary relationship to the expected cost of its assumption. While it may be that certain buyers and sellers will be able to identify and value any contingent liabilities

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[58] *See supra* note 30 and accompanying text.

related to prepaid income, this is likely to be the exception rather than the rule. Much more likely is that the parties will not assign *any* value to these liabilities in the governing agreements.

Third, the expected costs of fulfillment of the buyer and the seller may actually differ. For example, the buyer may intend to operate the business in a different manner than the seller, or may have access to other resources not available to the seller (*e.g.,* more efficient machines and/or a more skilled workforce) to fulfill the prepaid contracts. If so, the size of the *Pierce* payment projected by the buyer may differ from the size projected by the seller.

Fourth, the parties will usually not have adverse interests in negotiating the agreed value of the contingent liabilities, so an agreed value would not usually reflect true arm's length bargaining. The buyer would desire to minimize the agreed value in order to minimize the resulting *Pierce* payment.[59] The seller would often be indifferent because the seller's deduction will generally offset the seller's income inclusion (although if the seller had unusable capital losses a larger agreed value would be beneficial because of the resulting increased capital gain and ordinary deduction).[60]

Finally, it makes no sense for the tax treatment of the parties to the transaction to depend upon such vagaries of the negotiating history as whether the price was reduced to reflect a contingent liability. A buyer will often bid a price for a business without even telling the seller what factors went into the price. And even if the contingent liability is discovered by the buyer during the course of the negotiations after a tentative price has been offered, future changes to the offered price may be based on an overall evaluation of numerous factors by the buyer without

[59] The IRS would have just the opposite incentive.

[60] Another reason the Fragmentation Approach is problematic is that any obligation to "earmark" specific assets as the medium of payment for the separate assumption would be inherently arbitrary, as well as inconsistent with the principles of Section 1060.

any explicit statement of how each factor affected the offer. In any event, there is no logical policy reason that the tax results should depend upon whether the buyer explicitly, as opposed to implicitly, reduced its price for the contingent liability.

The Assumption Approach avoids all of this complexity because the rules governing the assumption of other contingent liabilities leave the transaction "open" to the buyer. The basis adjustment is simply suspended until the liability becomes fixed, obviating the need to value the liabilities at closing. Already the default rule governing both fixed and contingent liabilities, it will be much simpler to administer. The Assumption Approach also conforms to the general expectation that buyers do not recognize immediate income in a purchase of assets.[61]

5. Impact of Competing Paradigms on the Seller.

It should also be noted that the tax impact on the seller of either paradigm is not materially different. Suppose, for example, that the seller, after receiving an advance payment from a customer that was taxable upon receipt, immediately sold its business to the buyer subject to the contractual liability. Although a buyer would pay exactly the same price for the business, the gain to the seller under a *Pierce* line of analysis would be reduced by the advance payment, increasing the seller's basis in the sold assets. The seller would therefore recognize no additional net income from the prepayment. Now suppose that the seller was instead permitted to defer the original advance payment. Applying a *Pierce* line of analysis, although the sale would require the seller to report the advance payment as income, it would also entitle the seller to an offsetting deduction for the deemed payment to the buyer in satisfaction of the liability. Again, the seller would recognize no additional income from the prepayment. Finally, suppose that the advance

[61] We also note that it is unusual to disaggregate a single, unified transaction into separate parts and to tax those parts differently. In fact, the IRS made this very observation in the case of an assumption of a deferred revenue liability in a non-recognition transaction, expressing concerns under the step transaction doctrine and the potential for abuse given the relationships among parties in such transactions. *See* Section III.B.2., *supra*.

payment is instead treated as a contingent liability. The seller would report the contingent payment as part of its amount realized in the sale, but with an offsetting deduction or basis adjustment attributable to its deemed satisfaction of the liability. Under all three scenarios, therefore, the seller recognizes the same amount of economic income.

6. Prepaid Income does not "Disappear" under Assumption Approach.

If deferred revenue is treated as a contingent liability, the buyer will be required to capitalize into basis the actual costs of fulfillment. Under the Assumption Approach, therefore, these costs effectively become nondeductible to both the buyer and the seller. If the buyer is instead treated as "stepping into the shoes" of the seller, it would report as current income the liability that the seller was relieved from as a result of the sale, but would be permitted to deduct the actual costs of fulfillment. In addition, the buyer would claim additional basis in the acquired assets at closing in an amount equal to the current income inclusion at closing. Whether or not the buyer is required to recognize current income at closing, therefore, the aggregate taxes paid by the buyer will remain the same (ignoring timing differences):[62]

> *Example*: S holds a business worth $X dollars, subject to a deferred revenue liability of $15 attributable to certain prepaid customer contracts with a remaining term of three years. B and S specifically agree to reduce the cash purchase price to $X-$15 for the business. B then incurs $5 in fulfillment costs in each of Years 1-3.

Under the Fragmentation Approach, S incurs no net tax at closing because the $15 of income attributable to the deferred revenue liability is fully offset by a $15 deduction. Although B has additional income of $10 in Year 1 and additional deductions of $5 in each of Years 2-3, it

[62] Michael L. Schler, *Sale of Assets After Tax Reform, Section 1060, Section 338(h)(10), and More*, 43 Tax. L. Rev. 605, 670-674 (1988). *Compare* 1990 NYSBA Report (income recognition upon assumption of general contingent liability does not assure "tax neutrality" -- and thus seems to be an impractical approach -- because of the timing difference of current income recognition and deferred cost recovery).

also has an initial tax basis in the acquired assets of $X, $15 of which is attributable to the receipt of the taxable *Pierce* payment. B therefore includes $15 in gross income, claims $15 of deductions for the fulfillment costs, and claims $X as current depreciation over the useful life of the assets ($15 of which is attributable to the basis of the asset received for the funding of the *Pierce* payment).

Under the Assumption Approach, S again incurs no net tax at closing because the $15 of additional "amount realized" attributable to the contingent liability is fully offset by a $15 deduction or positive basis adjustment. B has no income at closing and an initial tax basis in the acquired assets of $X-$15. Over Years 1-3, B increases its basis in the acquired assets by $15 of fulfillment costs, to a total of $X. B therefore has no gross income at closing and claims $X of deferred depreciation over the useful life of the acquired assets.

The chart in Exhibit B of this report includes a useful summary of the net tax consequences of each approach to the buyer and the seller.

B. Limited Application of the Fragmentation Approach

In addition to the limitations described above, the application of the Fragmentation Approach to every taxable asset acquisition of a business with deferred revenue liabilities is likely to result in unexpected tax consequences to many buyers. Well-advised buyers will be able to comply so long as any future guidance is sufficiently clear. For many (if not most) buyers, however, it is likely to take some time before any new guidance is able to overcome the embedded expectation that the mere purchase of assets does not trigger current income.

If, contrary to our recommendation, Treasury and the IRS determine the Fragmentation Approach should apply to certain taxable asset acquisitions of a business involving the assumption of a deferred revenue liability, we recommend that future guidance clearly identify the precise circumstances under which it will apply, in all cases on a mandatory rather than

elective basis. We also recommend that the buyer and the seller should be required to report the *Pierce* payment on their tax returns and to be bound by such determination. Consistent with the current rules under Section 1060, however, the actual amount of any *Pierce* payment reportable by each party should be permitted to differ, reflecting each party's determination of the expected costs of fulfillment. Treasury and the IRS should also consider whether the presumptive amount of any *Pierce* payment should be the amount of the deferred revenue liability reflected on the GAAP balance sheet of the seller. Finally, any such guidance should clarify whether the medium of the *Pierce* payment consists of a pro rata portion of each of the acquired assets, a specific asset designated by the parties or first any cash being acquired.

C. Treatment of Fulfillment Costs

We believe that the treatment of fulfillment costs should follow the treatment of the assumption. If the Fragmentation Approach applies, the buyer should be permitted to deduct the fulfillment costs to the extent such costs would have been deductible to the seller. If the Assumption Approach applies, the buyer should be required to capitalize the costs under the same rules governing the assumption of other contingent liabilities.

## Exhibit A

This Exhibit A is intended to illustrate the application of both the Assumption Approach and the Fragmentation Approach in a simple asset acquisition involving an assumption of a deferred revenue liability. It reflects our understanding of how these approaches would apply based upon the limited guidance available. Although this report focuses on the tax treatment of the buyer in these transactions, the examples in this Exhibit A also describe the tax impact of each approach to the seller.

Facts:

Ignoring customer contracts, Seller owns a business consisting of two assets: $1 million in cash and $1 million in goodwill with a tax basis of zero. Immediately before the sale, the business has deferred revenue liabilities related to prepaid customer contracts of $1 million. Seller originally received the $1 million in the ordinary course of business as advance payments from customers on the contracts, which Seller was permitted to defer under the Code.

Seller agrees to sell the business subject to the deferred revenue liability to Buyer for $1.2 million. The agreed value of the deferred revenue liability is $800,000, which is the expected cost of fulfilling Seller's obligations on the prepaid contracts. In exchange for the acquired assets, Buyer pays $1.2 million and assumes the deferred revenue liabilities. Following the sale, Buyer incurs $800,000 in actual fulfillment costs.

Scenario 1: The Assumption Approach

**Treatment of Buyer**

Buyer treats the deferred revenue liability as a contingent liability. It therefore recognizes no income at closing and capitalizes (rather than deducts) the entire cost of fulfillment on the prepaid contracts as they are incurred. Buyer's initial tax basis in the acquired assets is $1.2 million, $1 million of which is allocable to the acquired cash and the remaining $200,000 of which is allocable to the acquired goodwill. As Buyer incurs the fulfillment costs, it increases its tax basis in the acquired goodwill by $800,000.

**Treatment of Seller**

Seller has an amount realized of $2 million, consisting of the $1.2 million of cash and $800,000 of assumed liabilities. Net of the seller's tax basis in the $1 million of cash, Seller realizes $1 million of capital gain, all attributable to the sold goodwill. Seller also has ordinary income of $1 million on triggering the deferred revenue, together with an ordinary deduction of $800,000. Seller therefore realizes $1 million of capital gain and $200,000 of ordinary income.

Note that if Seller had either retained the deferred revenue liability together with $800,000 of cash to fund the associated costs or satisfied the liability for $800,000 before the sale, its net after-tax proceeds following the sale of the business to Buyer would have been the same. It would have transferred $200,000 of cash and $1 million of goodwill for $1.2 million, resulting in $1 million of capital gain. Upon the satisfaction of the customer contracts, it would report $1

million of deferred revenue and $800,000 of deductible expenses, resulting in net ordinary income of $200,000.

Scenario 2: The Fragmentation Approach

**Treatment of Buyer**

Unlike Scenario 1, Buyer is treated as (i) purchasing $200,000 of cash and $1 million of goodwill for a cash purchase price of $1.2 million; and (ii) receiving an $800,000 *Pierce* payment for assuming the deferred revenue liability. Buyer's initial tax basis is therefore $2 million (rather than $1.2 million), $1 million of which is allocable to the cash and $1 million is allocable to the goodwill. Buyer realizes $800,000 of ordinary income upon receipt of the *Pierce* payment at closing, which it may defer to the same extent that Seller was permitted to do so when it received the original prepayment from its customers. Finally, Buyer deducts (rather than capitalizes) the $800,000 of fulfillment costs over the terms of the prepaid contracts. The $800,000 of ordinary income therefore offsets by the $800,000 of deductible fulfillment costs.

Note that if Buyer's actual fulfillment costs had been less than $800,000, Buyer would recognize income between the date of closing and the date of fulfillment equal to the difference.

**Treatment of Seller**

As in Scenario 1, Seller recognizes $1 million of ordinary income upon Buyer's assumption of Seller's performance obligations under the prepaid contracts and claims an ordinary deduction of $800,000 for the deemed *Pierce* payment. Seller is also deemed to have sold its remaining assets to Buyer (*i.e.,* $200,000 of cash and $1 million of goodwill). Seller therefore realizes $1 million of capital gain and $200,000 of ordinary income.

Note that if Seller had either retained the deferred revenue liability together with $800,000 of cash to fund the associated costs or satisfied the liability for $800,000 before the sale, its net after-tax proceeds following the sale of the business to Buyer would have been the same.

Scenario 3: Consequences of Varying Fulfillment Costs

Assume instead that Buyer's actual fulfillment costs on the prepaid contracts are either $900,000 (Case 1) or $700,000 (Case 2), or higher or lower than the $800,000 *Pierce* payment assumed by both Buyer and Seller at closing.

**Treatment of Buyer**

If the Assumption Approach applies, the tax consequences to Buyer are the same as those described in Scenario 1 except that in Case 1, Buyer will have a $1.1 million rather than $1 million tax basis in the acquired goodwill (which the parties valued at $1 million) and in Case 2, Buyer will have $900,000 rather than $1 million of tax basis in the acquired goodwill.

If the Fragmentation Approach applies, the tax consequences to Buyer are the same as those described in Scenario 2, except that in Case 1 Buyer will have an additional $100,000 ordinary deduction to offset unrelated income (a current tax benefit to Buyer). In Case 2, the tax

consequences to Buyer are also the same as those described in Scenario 2, except that Buyer will recognize an additional $100,000 in ordinary income (*i.e.,* the difference between the $800,000 *Pierce* payment and the actual fulfillment costs of $700,000).

**Treatment of Seller**

Buyer's actual fulfillment costs have no effect on Seller under either the Assumption Approach or the Fragmentation Approach.

## Exhibit B

## Summary of Outcomes for Buyer and Seller

X=gross value of acquired assets
P=prepaid revenue to seller
E=expected and actual fulfillment costs
X-E=buyer's cash payment to seller

| | **Fragmentation Approach** | | **Assumption Approach** | |
|---|---|---|---|---|
| | **Seller** | **Buyer** | **Seller** | **Buyer** |
| **Ordinary income** | P | E | P | 0 |
| **§1001 amount realized at closing** | (X-E) on portion sold; E on portion transferred for assumption of liability | 0 | X | 0 |
| **Deduction at closing** | E | 0 | E | 0 |
| **Tax basis before fulfillment** | | X | | X-E |
| **Effect of fulfillment** | | Deduct E | | Add E to basis |
| **Tax basis after fulfillment** | | X | | X |
| **Net total income or deduction including amortization** | Income of X+P-E- (basis of transferred assets) | Deduction of X | Income of X+P-E – (basis of transferred assets) | Deduction of X |