REPORT #671

TAX SECTION

New York State Bar Association

Report on the Federal Income Tax
Treatment of Contingent Liabilities
in Taxable Asset Acquisition Transactions

October 16, 1990

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New York State Bar Association

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November 1, 1990

The Honorable Fred T. Goldberg, Jr.

Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I enclose a Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions. Richard L. Reinhold drafted the report.

Our report makes recommendations designed to rationalize the tax treatment of both seller and purchaser where contingent liabilities are assumed in taxable asset acquisitions, including stock acquisitions treated as asset acquisitions under Section 338(h) (10) of the Internal Revenue Code.

Based on considerations of tax policy and administrability, we believe the proper tax treatment of such contingent liabilities should be that (i) the seller should not recognize income due to assumption of a contingent liability if the liability is of a type that would be deductible, (ii) subject to limited exceptions based on certain case law precedents, the purchaser should be able to deduct any resulting liability when the usual tests for deducibility are satisfied and (iii) the purchaser should not be required to recognize income by reason of its assumption

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of the liability, thus rejecting a possible theory that would treat the purchaser as having income by reason of its receipt of a portion of the acquired assets as considered for assumption *of* the liability.

The report urges that the Service publish a ruling or rulings embodying these conclusions and make conforming changes to the Section 338 regulations.

We would be pleased to discuss the report and the issues it presents with your staff at their convenience.

Very truly yours,

Arthur A. Feder
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Enclosure

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions

October 16, 1990

I. Introduction

This report[1] addresses the federal income tax treatment of contingent liabilities in the context of taxable acquisitions of assets of an operating business.[2]

Relatively few case law and administrative precedents have considered the important questions presented in this area. Moreover, the precedents are to some degree contradictory and the state of the law is uncertain in important respects. We also believe that certain significant cases and pronouncements have failed to place the issues considered in proper context, and therefore can be read to suggest results that, in our view, are impractical as well as unsound from a policy viewpoint. Because of the notable shortcomings in the precedents in this area, taxpayers engaging in asset

[1] Richard L. Reinhold drafted this report. Helpful comments were eceived from Peter C. Canellos, Herbert L. Camp, John A. Corry, Arthur A. Feder, Gordon D. Henderson, Donald Schapiro, Dennis E. Ross, Michael L. Schler and Ralph O. Winger. The persons commenting on the report do not necessarily agree with each of -the report's recommendations,.

[2] As used herein, *a* taxable asset acquisition includes both the purchase of the assets of an operating business for cash or other taxable consideration as well as a corporate stock acquisition that is treated as an asset purchase pursuant to Section 338(h)(10) of the Internal Revenue Code of 1986, as amended (the "Code"). Except as noted, "Section" references herein are to the Code, and references to "Treas. Reg. § ____" are to the Treasury Regulations thereunder.

acquisitions where contingent liabilities are present are faced with a significant risk of overtaxation. In addition, otherwise sound business transactions have been made riskier and more expensive.

The uncertain and to some degree illogical state of the law in this area has taken on materially increased practical significance due to the growing number of situations in which contingent liabilities — potentially involving very large amounts— follow the assets of an acquired business. Examples include environmental liabilities, liabilities to employees and former employees for health benefits and liabilities relating to defective products. We note that various proposals have recently been considered in Congress to provide for the funding of such major expenses as retiree medical expenses; and that, at the same time, a major debate is ongoing within the accounting profession as to the correct treatment of such liabilities for financial accounting purposes. It would indeed be ironic if the incorrect tax treatment of these costs in effect increased the already substantial burden these costs represent.

It is the thesis of this report that the proper tax treatment of most contingent liabilities of an acquired business should be (i) no income recognition by the Seller[3] due to assumption of a contingent liability (assuming that the liability is of a type that is deductible), (ii) subject to certain exceptions, deduction of the liability by the Purchaser when the usual tests for deductibility are satisfied (generally, the "all events" test and the economic performance standard of Section 461(h)) and (iii) no requirement of income recognition by the Purchaser as a result of assuming a contingent liability (thus rejecting a possible theory that would effectively treat the Purchaser as an "insurer" having income through the Seller's transfer of a portion of the acquired assets to the Purchaser as consideration for the Purchaser's assumption of the contingent liability).

It is submitted that the foregoing tax treatment (i) imposes the appropriate tax burdens on the Purchaser and Seller no later (but possibly earlier) than the appropriate time for imposing tax, (ii) alleviates significant administrative complexity for

[3] As used in this report, "Seller" designates both the person that sells the assets of an operating business as well as the "old target" which is deemed to have sold all of its assets in a corporate stock sale subject to a Section 338(h)(10) election. Treas. Reg. § 1.338(h)(10)- lT(e)(l). Similarly, "Purchaser" designates the purchaser of the assets of an operating business, as well as the "new target" which is the deemed asset purchaser in a corporate stock acquisition subject to Section 338(h)(10). Treas. Reg. § 1.338(h)(10)-lT(e)(l)-(3).

both taxpayers and the Internal Revenue Service, (iii) subject to appropriate safeguards, should create no opportunity for abuse and (iv) represents a tax-neutral regime with no bias either favoring or burdening acquisitions of operating businesses.

We would, however, require Purchaser capitalization —-*i.e*., inclusion of amounts paid in the tax basis of the acquired assets -— for liabilities assumed from the Seller in two limited contexts: (i) deferred compensation in the form of an annuity payable on account of arrangements with former employees of the business and (ii) claims being contested by the Seller at the time of the transfer. Although we do not necessarily endorse the correctness of this treatment from a tax policy viewpoint, we think the indicated results may be unavoidable under case law precedents. We also note that it would be appropriate to treat a portion of each payment made with respect to these liabilities as deductible interest, with the balance of the payment being regarded as a capital cost.

We recommend against an approach that would require current valuation of assumed contingent liabilities. Although such an approach has theoretical merit, we think it would be unadministrable in practice.

We recommend that the Internal Revenue Service publish a revenue ruling embodying the foregoing conclusions and make conforming changes to the Section 338 regulations. Although certain case law precedents may be read to be inconsistent with the general approach we recommend for treatment of the Purchaser, we believe the Service could adopt the recommended approach without legislation. We note that in the analogous area involving the treatment of accounts payable by a cash method taxpayer in a Section 351 transaction, the Service rejected similar precedents that would have demanded a result at variance with sound tax policy and common sense.[4]

The balance of this report is divided into three parts. Part II discusses the existing precedents and authorities governing the treatment of fixed and contingent liabilities in the context of taxable asset acquisitions, and the treatment of such liabilities in the Section 351 and 357(c) context, which is closely related. Part III contains a detailed analysis of the recommended approach, including the tax policy considerations and an analysis of a hypothetical fact pattern demonstrating that the recommended approach would not result in undertaxation of the parties to the transaction.

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[4] Compare Rev. Rul. 80-198, 1980-2 C.B. 113 with Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946).

Part IV discusses certain additional issues presented by the approaches we have rejected.

The report does not deal with the treatment of contingent liabilities in carryover basis transactions governed by Sections 332 and 354. Apparently, the rules of Section 381 (c)(4) and (c)(16) and the regulations thereunder-— which generally allow the successor to "step into the shoes" of the predecessor — for the roost part achieve proper and symmetrical results.

II. Precedents and Authorities Regarding the Tax Treatment of Liabilities in Asset Acquisition Transactions

Before describing the precedents relating to contingent liabilities, it is useful to consider the precedents in the area of fixed liabilities, which are relatively well-settled.

A. Rules Governing Fixed Liabilities

(i) Treatment of Seller

A Seller of property whose fixed liability is assumed in connection with a transfer of property realizes income in the amount of the liability.[5] (No distinction is intended to be made herein between the Purchaser's "assumption" of a liability of the Seller as contrasted with the Purchaser's acquiring the Seller's property "subject to" a liability encumbering the property.) This conclusion holds true whether the liability is recourse or non-recourse.[6]

In the case of a Seller that uses the cash method of accounting, the assumption of a deductible liability that has accrued but not been paid (and therefore not previously been deducted) triggers the deduction on the premise that the Purchaser's assumption is tantamount to the Seller's payment of the liability.[7] Recently proposed regulations under Section 461(h) adhere to the deemed payment approach of the case law, and consider the "economic performance" requirement satisfied as regards liabilities assumed in the case of a transfer

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5 Treas. Reg. § 1.1001-2; Crane v. Commissioner, 331 U.S. 1 (1947). Income from cancellation of indebtedness, rather than an amount realized results where a recourse debt is assumed in conjunction with the acquisition of property having a value less than the amount of the debt. Treas. Reg. § 1.1001-2(a)(2).

6 Treas. Reg. § 1.1001-2.

7 Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981); Cooledqe v. Commissioner, 40 B.T.A. 1325 (1939), Acq., 1940-1 C.B. 2. But see Fisher Cos, v. Commissioner/ 84 T.C. 1319 (1985), aff'd without opinion 806 F.2d 263 (9th Cir. 1986), discussed infra note 28.

of a trade or business.[8] However, this relief is limited to situations in which the liability is "expressly" assumed, the amount of the assumed liability is included in income, and there is no o tax avoidance motive for the sale of the business.[9] The "payment" analogy is not complete, however, and where deductibility is subject to Section 404, the Purchaser's assumption does not trigger deductibility, at least in the view of the Service.[10]

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[8] Proposed Treas. Reg. § 1. 461-4 (g) (1) (ii) (C) . The regulations state that economic performance is considered to occur "as the amount of the liability is included in the amount realized on the transaction by the taxpayer." The premise of the regulation that gain recognition resulting from assumption of a liability occurs at the time of payment of the liability is consistent with the approach of the Section 338(h)(10) regulations, but not, apparently, with the rule in the Section 1060 context. See the discussion at note 61, infra

[9] Id. Although the general approach of the proposed regulations is clearly sound as regards the treatment of assumed deductible liabilities, we question the need for restricting relief to liabilities "expressly" assumed. Initially, it is not clear how an express assumption could occur in a stock acquisition subject to a Section 338(h)(10) election, although such a transaction would clearly constitute the acquisition of a trade or business in which all liabilities of the acquired business have been assumed. Second, it may be impractical to identify unknown or speculative liabilities. Nonetheless, as indicated by the basic rule itself, there is no general opportunity for tax avoidance in the ability to offset the income and related expense that derive from assumption of a deductible liability.

[10] LTR 8939002 (June 15, 1989) (purchaser's assumption of deferred compensation liability was not "payment" thereof within the meaning of Section 404 (a) (5)).

(ii) Treatment of Purchaser

The Purchaser treats an assumed fixed liability as a cost of the acquired property and accordingly includes such amount in its tax basis.[11] To the extent the liability assumed is a deductible item as to the Seller, the Purchaser is not entitled to a deduction based on the character of the assumed liability; which is accorded the same treatment as a nondeductible item.[12] Due to the reflection of the liability in the basis of the acquired asset, the Purchaser may, of course, obtain a deduction through its recovery of basis (via amortization, depreciation, cost of goods sold, etc.).

(iii) Sections 338(h)(10) and 1060

The treatment of the Seller's amount realized and the Purchaser's cost basis for acquired assets generally conforms to the foregoing principles

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11 E.g., Lifson v. Commissioner, 98 F.2d 508 (8th Cir. 1938), cert. denied, 305 U.S. 662 (1939); John Hancock Mutual Life Ins. Co. v. Commissioner, 10 B.T.A. 736 (1928).

12 E.g., Maqruder v. Supplee, 316 U.S. 394 (1942) (denying deduction for assumed real property taxes allocable to the period after the acquisition, but for which seller was personally liable); Hyde v. Commissioner, 64 T.C. 300 (1975) (acquiring party entitled to deduct interest paid on assumed obligation only to the extent accrued subsequent to acquisition); see also Section 164(d) (reversing the holding of Magruder v. Supplee, supra, and allocating deduction for real property taxes based on period of ownership).

both in the Section 338(h)(10) context, and where Section 1060 applies.

In a stock acquisition treated as an asset acquisition under Section 338(h)(10)f the deemed sales price received by the old target includes fixed liabilities of the corporation.[13] Such liabilities are similarly reflected in the cost basis of the new target's assets.[14] The deemed sales and purchase prices, respectively MADSP and AGUE, are then allocated among the sold and acquired assets using the residual allocation method.[15]

In the case of an asset acquisition governed by Section 1060, the Seller's amount realized and

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13 Treas. Reg. § 1.338(h)(10)-lT(f)(2), (3)(ii). The old target's total selling price for its assets is the "modified aggregate deemed sales price" or "MADSP."

14 Treas. Reg. §§ 1.338(h)(10)-lT(e)(6)(i)(C), 1.338(b)- IT(f) (liabilities at the time of acquisition are those obligations that represent "a bona fide obligation of target as of that date which is properly includible in basis under principles of tax law that would apply if new target had acquired old target's assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the obligation"). The new target's total purchase price for the target's assets is the "adjusted grossed-up basis" or "AGUE." AGUE is equal to MADSP notwithstanding the differing definitions.

15 Treas. Reg. §§ 1.338(h)(10)-lT(e)(6)(ii),-IT (f)(2)(ii)(B), 1.338(b)-2T.

Purchaser's cost basis take into account liabilities as described in subsections (i) and (ii), above.[16] The resulting amounts are then allocated among the assets of the business using the residual method as prescribed by the Section 1060 regulations.[17]

Neither the Section 338 nor the Section 1060 regulations deal expressly with assumptions of deductible liabilities. In a Technical Advice Memorandum ("TAM") in the Section 338 context, the Service took the view that the assumption of a deductible fixed liability triggered both income and an offsetting deduction to the Seller.[18] Although the TAM analyzed the treatment of amounts in a vacation pay suspense account under the specific provisions of Section 463, it acknowledged that the same result would be reached under the rationale of James M. Pierce Corp. v. Commissioner[19] and Commercial Security Bank v. Commissioner.[20] This reasoning should apply in the Section 1060 context as well.

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16 Treas. Reg. § 1.1060-lT(c)(1).

17 Treas. Reg. § 1.1060-lT(d).

18 LTR 8741001 (June 16, 1987) (issue 1).

19 326 F.2d 67 (8th Cir. 1964), discussed infra at notes 24-26.

20 Supra note 7, discussed infra at notes 27-28.

(iv) Comment on Treatment of Fixed Liabilities

The tax treatment of a fixed liability can be explained by viewing the Purchaser as having paid cash to the Seller equal to the amount of the liability, with the Seller then satisfying the liability with the cash received.[21] Analyzed in this manner, the tax treatment summarized above is intuitively correct: the Seller treats the cash received as an amount realized, and, where a deductible liability of a cash method taxpayer is in question, gains a deduction through the deemed payment. The Purchaser takes a cost basis under Section 1012 equal to the cash deemed paid.[22]

B. Rules Governing Contingent Liabilities

(i) Treatment of Seller

While precedents are sparse (and perhaps contradictory in the Section 338 setting, as discussed in Part II.B.(ill), *infra*), it is reasonably clear

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21 *See* *Cooledge* v. *Commissioner*, *supra* note 7, 40 B.T.A. at 1328-29.

22 Although an assumed liability effectively represents an obligation to make deferred payments, the imputed interest rules are not applicable for purposes of determining whether unstated interest is present unless the assumed obligation is modified as part of the transaction. Section 1274(c)(4); Proposed Treas. Reg. § 1.483-1(d); Proposed Treas. Reg. § 1.1274-7(a).

that the Seller does not recognize net income by reason of the Purchaser's assumption of a contingent liability.[23] The approach taken by present law is not wholly clear, but some insight can be gained from James M. Pierce Corp. v. Commissioner.[24] At issue in Pierce was the tax treatment of an unearned subscription reserve where the newspaper business to which the reserve related had been sold. The reserve represented subscription amounts that had been received but not yet included in income under the taxpayer's method of accounting. The Tax Court held that the unrecovered balance of the reserve was required to be[25] included in income at the time of the acquisition. The Court » of Appeals for the Eighth Circuit agreed that recapture of the reserve was required, but went on to hold that an offsetting deduction was permitted since the reduction in cash consideration to the Seller by reason of the liability assumption amounted to a de facto

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[23] But 'see Fisher Cos. v. Commissioner, supra note 7

[24] Supra, note 19.

[25] 38 T.C. 643 (1962).

(deductible) payment by the Seller.[26]

The logic of Pierce was adhered to in Commercial Security Bank v. Commissioner,[27] in which the "accrued business liabilities" (largely interest expense) of a cash method bank were held deductible against the accrued interest receivables triggered into income

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26 The Court stated:

> "By Prairie's assumption of the obligations which those reserves represented, the taxpayer's cash received on the sale of the business was reduced. This is just as much an out-of-pocket payment by the taxpayer as if it had first received the gross amount from Prairie and then repaid Prairie cash equal to the amount of the reserves. It is just as much an out-of-pocket payment by the taxpayer as if, in fiscal 1957, it had used other, available cash of its own and. on its own initiative refunded the subscribers the amounts of their unearned or redeemable subscriptions.
>
> "This either would constitute a deductible business expense under 162(a) or it would operate in reduction, and here, by reason of identity of amounts, on elimination, of the income includable with the cessation of the need for the reserves. In either case, the result is the same."

326 F.2d at 72. In Rev. Rul. 68-112, 1968-1 C.B. 62, the Service held that the seller's deferred subscription reserve under Section 455 was triggered into income upon a sale of the business, but that a "separately stated" amount paid to the purchaser for the purchaser's agreement to assume the unearned subscription obligations was deductible under Section 162. The treatment of the purchaser was later considered in Revenue Ruling 71-450, 1971-2 C.B..78, discussed infra at notes 50-51.

27 Supra note 7.

upon sale of a banking business, again based on the notion that assumption of the liabilities was the functional equivalent of payment thereof.[28]

Similarly, if the assets of an acquired business are burdened by an obligation which is deductible in principle but fails to satisfy Sections 404(a), 461(h) or similar limitations, it can be reasoned that if the Seller has income by reason of its relief from the liability, it ought to have an offsetting deduction for the payment of the expense. However, a Technical Advice Memorandum would not allow a deduction under Section 404(a), apparently until the Purchaser pays the

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[28] Additional support for the above "netting" approach is found in Crane v. Commissioner, supra note 5, where the Commissioner conceded (with the approval of the Supreme Court) that the Seller's amount realized by reason of the mortgage assumption did not include assumed interest which represented a deductible item. 331 U.S. at 13 n.34. See also Focht v. Commissioner, 68 T.C. 223 (1977), Acq., 1980-2 C.B. 1 (holding deductible liabilities of a cash-method taxpayer not to constitute liabilities for ' purposes of Section 357(c)). To the contrary is the decision in Fisher Cos, v. Commissioner, supra note 7, which involved the assumption of an obligation to make repairs to a roof, expenditures which the Seller would presumably have been entitled to deduct, in which without citation of pertinent authority, or indeed even a reference to the possibility that the Seller might have been entitled to a deduction, the Seller was held to have income equal to the agreed value of the liability. 84 T.C. at 1347-49. Fisher has not been cited in any other case or ruling for its decision on this point.

employee.[29] In addition, although the recently-proposed regulations under Section 46l(h) would treat the Purchaser's assumption of liabilities as payment in the context of an acquisition of a trade or business, such treatment is limited to items as to which the "all-events" test is otherwise satisfied.[30]

While no authority expressly so holds, it seems likely that the Seller would have income upon the assumption of a non-deductible contingent liability (e.g., a contingent liability for federal taxes, or an obligation to pay a fine to a governmental entity) .' It is not believed that the assumption of such contingent - liabilities occurs commonly.

(ii) Treatment of Purchaser

The treatment of the Purchaser who assumes a contingent liability is not altogether clear. Three alternatives appear possible:

> Alternative 1: Purchaser deducts the amount of the liability when it becomes fixed, applying the all-

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29 See note 10, supra.

30 See note 8, supra. As a matter of tax policy, there would appear to be no reason to limit the deemed payment treatment to situations where the all-events test is otherwise satisfied.

events test,[31] as well as other limiting provisions such as Sections 404 or 461(h).

Alternative 2: Purchaser includes the amount of the liability in its cost basis for the acquired assets, but only as the liability is satisfied, similar to the treatment of contingent purchase price amounts.[32]

Alternative 3: Purchaser (i) includes the amount of the liability in income upon its assumption thereof, (ii) includes the amount of the liability in the tax basis of the acquired assets currently, and (iii) deducts the amount of the liability when it is satisfied.

Alternative 2 has the greatest, but not uniform, support. Alternative 1 is supported by selected decisions. There is little direct support for Alternative 3.

In David R. Webb Co. v. Commissioner,[33] a pension-type liability was assumed in connection with the acquisition of assets of an operating business. The obligation, incurred by a previous owner of the business, required lifetime payments to a widow under the employment agreement with an employee who

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31 Treas. Reg. § 1.461-l(a)(2).

32 Rev. Rul. 55-675, 1955-2 C.B. 567; see Treas. Reg. § 1.338(b)-3T(c); see also Albany Car Wheel Co. v. commissioner, 40 T.C. 831 (1963), aff'd per curiam, 333 F.2d 653 (2d Cir. 1964).

33 708 F.2d 1254 (7th Cir. 1983). The differing treatment of "assumed" liabilities relating to qualified pension plans is discussed in Part IV. D., infra.

had died before the acquisition. Agreeing with the Tax Court,[34] the Court of Appeals held that payments to the widow represented nondeductible capital expenditures that must be added to the cost of the acquired assets. As support for this proposition, the Court cited Magruder v. Supplee, supra.[35]

Pacific Transport Co. v. Commissioner[36] involved an acquisition subject to former Section 334(b)(2) in which the purchaser succeeded to an obligation to make payments relating to the cargo of a vessel lost at sea. At the time of the stock acquisition, the liability was expected to be minimal, but reversal of a prior judicial decision subsequent to the acquisition resulted in a significantly greater liability to the acquirer.[37] The Tax Court allowed the acquirer's deduction, reasoning that the liability was extremely speculative and remote, so that the parties could not have intended it to be reflected in the purchase price.[38] It also relied on

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[34] 77 T.C. 1134 (1981).

[35] 708 F.2d at 1256.

[36] 29 T.C.M. 133 (1970), rev'd per curiam, 483 F.2d 209 (9th Cir. 1973), cert, denied, 415 U.S. 948 (1974).

[37] 483 F.2d at 211-12.

[38] 29 T.C.M. at 167.

United States v. Minneapolis & St. Louis Ry.[39], which had allowed a purchaser to claim a deduction for assumed compensation expense allocable to the seller's period of ownership.[40] Finally, the court took note of the "extreme difficulties" that would attend an adjustment to the purchase price years after the fact.[41]

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39 260 F.2d 663 (8th Cir. 1958).

40 29 T.C.M. at 167. Minneapolis & St. Louis Ry. Co. involved a compensation award that applied retroactively to a period prior to the taxpayer's ownership of the business. Upholding the District Court (57-2 U.S.T.C. f 9964 (D. Minn. 1957)), the Court of Appeals allowed the purchaser to claim the deduction, and rejected the applicability of Holdcroft Transportation, supra note 4, generally on the bases that (i) the transferor was not itself legally obligated to pay the additional wages (the award having been made after the transfer had ceased to exist) and (ii) the transferee had not assumed the transferor's obligation to make the payment, a finding that is difficult to fathom in light of the broad assumption agreement entered into between the parties. The court's strained reading of the facts was plainly intended to support what it believed to be the correct result — purchaser deductibility of the liability.

41 The Tax Court stated as follows:

> "We have . . . ascertained that, under the facts present here, the difficulties of allocation, recomputations of bases and allowable depreciation, and of gain or loss on sales of assets prior to 1959 are so enormous and complex as to render impractical calculations to follow from a capitalization of the expenditure in question. Moreover, in view of further reorganizations prior to 1959, and sales of some of Old States' assets prior to 1959, New States could not recover a substantial amount of the proposed capitalization, taxwise. The principle that taxation is a practical concern of both the taxpayer and the Government, when applied to the facts here, militates in favor of petitioners and against respondent's assertions."

29 T.C.M. at 170.

The Ninth Circuit Court of Appeals reversed the Tax Court. Citing Woodward v. Commissioner[42] and United States v. Hilton Hotels Corp.,[43] the Court held that payment of the liability represented a capital cost incurred in connection with the acquisition of property. (Woodward and Hilton Hotels' treated the costs of an appraisal proceeding relating to the acquisition and squeeze-out, respectively, of minority stock interests as capital expenditures.)

F. & D. Rentals v. Commissioner[44] involved the treatment of a purchaser's assumption of obligations to make certain payments to a pension trust. The taxpayer first argued that the assumption itself constituted payment of the liability, thereby satisfying the payment requirement of Section 404(a).

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[42] 397 U.S. 572 (1970).

[43] 397 U.S. 580 (1970).

[44] 44 T.C. 335 (1965), aff'd, 365 F.2d 34 (7th Cir. 1966), cert, denied, 385 U.S. 1004 (1967).

The Tax Court held, however, that an assumption of a liability was not the equivalent of payment to the plan trustee; and that since the purchaser had not timely made the contribution it was not entitled to a deduction.[45] In response to the taxpayer's assertion that it should then add the liability to its tax basis in the acquired assets, the court observed that such treatment would represent an indirect means to obtaining the same deduction, and thus would involve circumvention of the purpose of Section 404.[46] The Court of Appeals agreed with the Tax Court that payment had not occurred.[47] The Court then went on to say that if payment had in fact been made the taxpayer would have been entitled to a deduction.[48] The F. & D. Court then held that the amount of the liability could not be added to basis currently due to its contingent nature (citing, i.a., Albany Car Wheel, supra); it appears, however, that basis would be provided at the time of payment.

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45 44 T.C. at 349.

46 Id.

47 365 F.2d at 41.

48 Id. The Court in David R. Webb Co. v. Commissioner, supra note 33, declined to follow this approach, however. 708F.2d at 1257-58.

Alternative 3 (current income to Purchaser/increased basis currently/deduction of expense when paid) is supported by an implication arising out of James M. Pierce Corp. v. Commissioner, supra. After holding that the Seller was not in receipt of income, on a net basis, upon recapture of its subscription reserve due to the presence of a deemed offsetting payment to the Purchaser, the court acknowledged the issue presented for the Purchaser:

> "There has been some comment about Prairie's income tax situation in 1957. That, however, is another taxpayer and not this one. We venture to observe only that if Prairie was on the accrual system and also was entitled to the benefit of I.T. 3369 [allowing deferral of subscription income for years prior to the effective date of Section 455], any income it may have realized in 1957 is offset by its deferment."[49]

In Revenue Ruling 71-450,[50] the Service held on facts similar to Pierce that the Purchaser was required to include in income the amount paid by the Seller as consideration for the Purchaser's agreeing to fill the prepaid subscriptions. Later private rulings confirmed that the Purchaser also was able to defer the income by virtue of Section 455, as well as to deduct

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49 326 F.2d at 72.

50 Supra note 26.

the costs of discharging the liability in the future.[51] To illustrate the approach taken in Revenue Ruling 71-450 and the later private rulings, assume that the acquired business had gross assets of $100 with a tax basis of $40, and a $10 liability for unpaid subscriptions. Purchaser would pay $90 for the business. Under the approach of the revenue ruling, (i) the Purchaser would be deemed to have paid $100 to Seller for the assets (giving the Purchaser an additional $10 of basis currently by reason of the assumption of the contingent liability), (ii) the Seller would be deemed to pay $10 to the Purchaser as consideration for the assumption of the unfilled subscription liability, thereby producing current income of $10 to the Purchaser, and (iii) the Purchaser's later incurrence of expenses in filling the subscriptions would be deductible. There appears to be no support for Alternative 3 outside the publication industry where Section 455 allows the Purchaser to defer recognition of the deemed income.

(iii) Sections 338|h)(10) and 1060

We deal first with the Purchaser under Section 338(h)(10). As previously discussed, the Purchaser's

[51] E.g., LTR 8749076 (September 11, 1987); LTR 8612050 (December 23, 1985).

basis in the acquired assets is AGUE, which includes fixed liabilities.[52] Obligations that are not fixed, and therefore are initially excluded from AGUB are required to be taken into account in "redetermining [AGUB] and the basis of target's assets under principles of tax law that would apply if new target had acquired old target's assets directly from an unrelated person and, as part of the transaction, had assumed or taken property subject to those obligations."[53]

Treas. Reg. § 1.338(b)-3T provides detailed rules relating to subsequent adjustments to AGUB. Although the definition of contingent liability contained in -3T(b)(2)(ii) (a liability that is "not fixed and determinable") is not particularly enlightening, the regulations indicate that the change in a target liability to one which is fixed and determinable triggers operation of the -3T adjustment rules,[54] with the amount of the liability being capitalized and added to basis, and allocated among; the target assets in accordance with the -2T regulations.[55] No differentiation is made in the

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52 Treas. Reg. § 1.338(b)-lT(f)(2).

53 Treas. Reg. § 1.338(b)-lT(f)(2)(ii).

54 Treas. Reg. § 1.338(b)-3T(a)(1), -3T(j), Example l(iv).

55 Treas. Reg. § 1.338(b)-3T(d).

regulations between deductible and non-deductible liabilities. As such, the regulations reflect positions consistent with the approach taken in Pacific Transport and Webb.

The structure of the regulations generally is similar as regards the Seller. Its amount realized, MADSP, includes only fixed liabilities.[56] The regulations then set forth the following rules governing the Seller's treatment of contingent liabilities:

> "Pursuant to general principles of tax law, the price at which old target is deemed to have sold its assets shall be adjusted to take into account adjustment events occurring after the acquisition date. In making such an adjustment, recognition of income (or loss) under this paragraph (h) with respect to the deemed sale of assets is not precluded because the target is treated as a new corporation after the acquisition date. To the extent general tax law principles require seller to account for adjustment events, target (or a member of the selling consolidated group in the event of an election under section 338(h)(10)) shall make such an accounting, which may result in reporting income, loss, or other amount."[57]

The meaning of this language is far from clear as regards contingent liabilities. First, as discussed in Part II.B.(i), supra, it would seem to be the better view of present law that "general principles of tax law" do

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[56] Treas. Reg. § 1.338(h)(10)-lT(f)(3)(ii)

[57] Treas. Reg. § 1.338(b)-3T(h)(1)(i).

not require a seller to include in the sales price of assets deductible contingent liabilities — either at the time of the purchase or when the liabilities become fixed.[58] Second, in practical terms, the seller will often have no knowledge of the relevant facts or amounts, and in all events an offsetting deduction has generally been held to be available if income is determined to be recognized.[59] Notwithstanding the foregoing, the 1987 TAM issued in the context of a Section 338 election not only assumes that the fixing of a contingent liability requires adjustment of the purchase price, but also makes the startling statement that "general tax law principles do not require the target [i.e., Seller] to report a deduction."[60] Perhaps not surprisingly in light of the statement just quoted, the TAM holds that the final sentence of regulation -3T(h)(l)(i) would not permit the seller to claim an offsetting deduction. As a result the TAM would apparently require the deemed seller to recognize income as the contingent liability (relating to future warranty claims) became fixed; but would allow no

[58] But see Proposed Treas. Reg. § 1.461-4(g)(1)(ii)(C), discussed supra notes 8 and 30.

[59] Pierce v. Commissioner, supra note 19; Commercial Security Bank v. Commissioner, supra note 7; Cooledge v. Commissioner, supra.

[60] LTR 8741001, supra note 10 (issue 2).

deduction for such amounts. The TAM further held that no deduction would be available to the deemed purchaser, citing Pacific Transport and Webb.

The Section 1060 regulations do not specifically address the treatment of contingent liabilities. The regulations simply define the Purchaser's consideration as its cost for the acquired assets and the Seller's consideration as the amount realized under Section 1001(b).[61] Similarly, the subsequent adjustment rules defer to "applicable principles of tax law."[62] As regards the Purchaser, subsequent adjustments in

61 Treas. Reg. § 1.1060-lT(c). It is clear that the amount realized under Section 1001(b) includes liabilities assumed by the Purchaser; however, there is no guidance on when income from the assumption of a contingent liability is recognized. Although the Section 338 regulations and the proposed "economic performance" regulations under section 461 discussed at notes 8 and 30, supra, adopt the view that income is recognized at the time of payment of the assumed liability, general principles of tax law would seem to mandate a preference for closed transaction treatment. See, e.g. Treas. Reg. § ISA.453-1(d)(2)(iii). Under this view, unless there are extraordinary circumstances which make it impossible to determine the value of the assumed contingent liability, the Seller would recognize income from the assumption of a nondeductible contingent liability at the time of the asset sale. See Schler, Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More, 43 Tax L. Rev. 605, 667 (1988).

62 Treas. Reg. S 1.1060-lT(f)(1).

purchase price are required to be allocated among the acquired assets employing the residual allocation rule.[63]

C. Treatment of Liabilities in Section 351 Transactions

(i) Treatment of Fixed Liabilities

An accrual method transferor in a Section 351 transaction generally will claim deductions for fixed liabilities accrued up to the time of transfer. The assumption of such fixed liabilities will then be subject to the rules of Sections 357(c) and 358(d), however, so that (i) if the liabilities in question (together with other liabilities assumed or taken subject to in the exchange), exceed the tax basis of the assets transferred in the exchange, gain recognition will be required,[64] and (ii) the transferor's basis in the stock of the transferee corporation, which ordinarily equals the sum of the tax basis of property transferred, increased by the amount of gain recognized and decreased by the amount

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63 Treas. Reg. § 1.1060-lT(f)(2).

64 Sections 357(c) is an exception to the general rule of Section 357(a) that the assumption of a liability in a Section 351 transaction does not give rise to taxable boot. Section 357(b) also overrides Section 357(a) where there is a tax avoidance purpose, but that rule is assumed not to apply in the circumstances addressed here.

of money received, will be decreased by the amount of the liabilities in question, because the same are treated as money received.

An accrual method transferee corporation will not be entitled to claim a deduction upon its payment of fixed liabilities assumed.[65]

If the transferor in a Section 351 transaction utilizes the cash method of accounting, it will not recognize gain on the transferee's assumption of deductible liabilities since such liabilities are not treated as liabilities for purposes of Section 357(c). Although this rule has, since 1978, been reflected in the Code,[66] the Service reached this same conclusion for transactions prior to the effective date of the 1978 change.[67] Initially, the Tax Court had treated the accounts payable of a cash method taxpayer as liabilities for purposes of Section 357(c).[68] However, later decisions

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65 Holdcroft Transp. Co. v. Commissioner, supra note 4; cf. Section 448 (generally requiring C corporations to utilize the accrual method).

66 Section 357(c)(3).

67 Rev. Rul. 80-199, 1980-2 C.B. 122.

68 Raich v. Commissioner, 46 T.C. 604 (1966).

disagreed with this result,[69] and ultimately the Tax Court altered its view in Focht v. Commissioner.[70] In reaching its conclusion in Focht, the Tax Court was strongly influenced by the treatment of assumed deductible expenses in Crane (i.e., such amounts were not included in the seller's amount realized[71]), and the fact that it was improper to "manufacture" gain where no taxable gain existed.[72]

In deciding to follow Focht, the Service reasoned that the transferor should be treated no more harshly than if he had not incorporated

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69 Bongiovanni v. Commissioner, 470 F.2d 921 (2d C-'r. 1972) (limiting Section 357(c) to "tax" liabilities; while not defined, tax liabilities may have been meant to include liabilities that arose in connection with borrowings or from prior tax accruals); see Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976) (holding cash method taxpayer's accounts payable to represent liabilities for Section 357(c) purposes; but allowing an offsetting deduction by treating the assumption as payment).

70 Supra note 28.

71 See note 28, supra.

72 The facts of Focht were typical: the transfer had significant accounts receivable, in which it had a zero basis, and significant accounts payable which had not been deducted. Although the receivables and payables might balance from an economic viewpoint as well as a tax viewpoint (assuming continued operation of the business), by . treating the payables as liabilities for purposes of Section 357(c), artificial gain recognition was required. The logic of Focht formed the basis for Congressional analysis in the adoption of Section 357(c)(3). See Joint Comm. on Taxation, General Explanation c! the Revenue Act of 1978 217-20 (1979) ("1978 Blue Book").

the business, and that it was inappropriate as a tax policy matter to create an artificial impediment to the incorporation of businesses.[73]

The 1978 amendments to the Code did not address the treatment of the accounts payable in the hands of a cash method Section 351 transferee.[74] Similarly, Focht refused to address the treatment of the transferee, although its citation to Magruder v. Supplee, supra, hinted fairly strongly that it thought the transferee should not deduct such amounts.[75] In Revenue Ruling 80-198,[76] the Service held that a deduction would be permitted to the transferee, provided the incorporation served a business purpose, and the transferor had neither accumulated accounts payable nor prepaid accounts receivable.[77]

In reaching the conclusion that the transferee should be permitted to deduct the assumed payables, the

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[73] See G.C.M. 37528 (May 3, 1978).

[74] The 1978 legislative history specifically stated that the transferee corporation's treatment was not addressed by the amendments. 1978 Blue Book at 219.

[75] 68 T.C. at 238.

[76] Supra note 4.

[77] 1980-2 C.B. at 113-14.

Service was forced to confront Holdcroft Transportation v. Commissioner,[78] which had squarely held that assumed liabilities in a Section 351 transaction represented a cost of the acquired assets and were not deductible. The Service felt that policy considerations should prevail: it was not desirable to create impediments to incorporation transactions, and, but for the indicated holding, the transferee would suffer a mismatching as income from the receivables was recognized.[79]

(ii) Treatment of Contingent Liabilities

Although no discovered authority directly addresses the tax treatment of the assumption of a contingent liability in a Section 351 transaction it appears reasonably clear that Section 357(c)(3) would apply to such items if they were of a deductible nature, with the result that such amounts would not be treated as liabilities for purposes of Section 357(c).

The treatment of the Section 351 transferee may be less certain. Holdcroft Transportation dealt with tort claims of a predecessor partnership that were transferred in a Section 351 transaction. The claims grew out of a

[78] Supra note 4.

[79] See G.C.M. 34118 (May 2, 1969).

collision in 1935 involving a truck operated by the partnership. The corporation succeeded to the partnership's business in 1939; later in that year a verdict was rendered establishing liability? The corporation paid the judgment and also settled the other claim.[80] Before the Eighth Circuit Court of Appeals, the taxpayer argued that the payments should be deductible because they were contingent and not liquidated at the time of the transfer, so that the later payment to preserve the business and credit of the taxpayer should not be considered a capital expense. Rejecting this assertion, the court stated:

> "The payment by pe##tioner of the claims against the partnership reasonably can be attributed only to the assumption by petitioner of liability for those claims. The claims did not arise out of the operation of the business of petitioner. The expense of settling them was not an operating expense or operating loss of that business, but a part of the cost of acquisition of the property of the partnership; and the fact that the claims against the partnership were contingent and unliquidated at the time of acquisition is not, in our opinion, of controlling consequence."[81]

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[80] 153 F.2d at 323-24.

[81] 153 F.2d at 324.

To a similar effect is M. Buten & Sons v. Commissioner,[82] involving death benefits payable to the widow of an employee of a predecessor partnership. Since the employee had died before the incorporation, the Tax Court viewed the liability to make continuing payments as part of the cost of acquiring the partnership's property, citing, inter alia, Holdcroft.[83] However, deductibility was permitted in the case of survivor's payments to a widow where the employee's death followed the incorporation.[84]

Following Revenue Ruling 80-198, however, the continuing vitality of Holdcroft is in question. For example, in Revenue Ruling 83-155,[85] the Service held that a successor corporation could deduct amounts paid to a previously retired partner or spouse of the retired partner of a predecessor partnership where the partnership's business had been incorporated. Rejecting the holdings in Holdcfoft and Buten, the Service instead adopted a broad rationale that appears to accord "step-in-the-shoes"

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82 31 T.C.M. 178 (1972).

83 31 T.C.M. at 181.

84 31 T.C.M. 182-83; see also G.C.M. 9274 April 23, 1984).

85 1983-2 C.B. 38.

treatment to a Section 351 transferee with respect to assumed liabilities.[86]

Thus, while the law cannot be regarded as clear, it would appear that the Service would allow the transferee to deduct contingent liabilities assumed in a Section 351 transaction.

III. Analysis of Proposal

A. Summary

As indicated, we believe the proper treatment of deductible liabilities assumed in an asset acquisition would generally accord non-recognition treatment to the Seller by

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[86] The Service stated:

> "The present case is analogous to the situation in Rev. Rul. 80-198. The taxpayer is making the same payments that the partnership was making. The payments would have been deductible by the partnership had the partnership continued in existence. The congressional intent to facilitate necessary business readjustments would be frustrated by not according to the transferee the right to deduct expenses of the ongoing business which, if not assumed by the transferee, would have been deductible by the transferor."

1983-2 C.B. at 39; see also G.C.M. 39054 (November 7, 1983), in which the Service's rejection of the holdings in Holdcroft and Buten is made explicit.

reason of the assumption; and deduction of the liability to the Purchaser-at such time as the all events test and other applicable limitations on deductibility were satisfied. The same rules would apply in the case of a Section 338(h)(10) transaction.[87]

The foregoing treatment of the Seller is, we think, amply supported by Pierce and Commercial Security Bank. Although this treatment of the Seller implicitly nets the income associated with assumption of the liability against the expense allowed by reason of the payment, we do not think such netting creates undesirable effects, as discussed in Part III.B.(i), infra. Moreover, we do not think this treatment of the Seller offends the policy considerations underlying Sections 404 or 461(h), as discussed in Part III.D., infra. We also discuss the need for a prophylactic rule to prevent efforts to disguise purchase price payments as assumed contingent liabilities (see Part III.E., infra).

On the Purchaser's side, although precedents such as Pacific Transport and Webb appear to require a

[87] In the relatively unlikely situation where a non-deductible contingent liability is assumed, the Seller should, of course, recognize income by reason of the assumption without any offsetting deduction.

contrary conclusion in cases involving liabilities for claims being contested by the Seller, and for annuity arrangements in respect of former employees of the Seller, our suggested approach is supported by the Tax Court's opinion in Pacific Transport (which, despite its reversal by the Ninth Circuit, we consider better-reasoned), as well as the opinion in F. & D. Rentals and the holding — although not necessarily the stated reasoning — in United States v. Minneapolis and St. Louis Ry., which allowed the Purchaser deductions for assumed compensation expense.

Moreover, we think Webb and Pacific Transport (as well as cases such as Holdcroft) are based on a faulty as well as impractical analysis. Without critically considering the issue, these cases have analogized assumed deductible liabilities to what may be called "tax-paid" liabilities, such as obligations to make payments in the nature of purchase price.[88] Although capital treatment obviously is appropriate in the latter case, we think it is not in the former. In addition, as indicated in greater detail in Part III.B., infra, we think according deductible treatment to the Purchaser is strongly supported by compelling considerations of tax

88 E.g., Woodward v. Commissioner, supra note 42; United States v. Hilton Hotels, supra note 43.

policy and administrability. We also discuss, in Part III.C., infra, why the proposed treatment creates no tax advantage-or tax sheltering opportunity.

As noted, in situations that clearly fall within the holdings of Webb and Pacific Transport, we would recommend adherence to the capitalization approach imposed by those decisions. However, we think it appropriate to recognize that the satisfaction of an assumed liability subsequent to the acquisition involves an interest element. Accordingly, we would recommend that when payment is made, a portion of the payment be treated as interest based on the period of time that has elapsed since the acquisition. In general, the approach taken in Proposed Treas. Reg. § 1.1275-4(f)(2) is consistent with our recommended approach.

B. Tax Policy Considerations

(i) Seller

Aside from considerations relating to Sections 404 and 461(h), the only real policy issue presented by the netting approach is whether differences in the character of the income and counterbalancing expense will open the door to unintended tax treatment. Clearly, where deductible liabilities are involved, the Seller will in most circumstances obtain no advantage through the offsetting of ordinary expense, on the one hand, and capital gain, Section 1231 gain or ordinary income on the other.[89]

One might contend that the Seller's income recognition is deferred from the time of the sale to the point at which the liability actually is satisfied, thereby implying a question as to the avoidance of the Section 453A interest charge. As a technical matter, however, the deferred payment of an assumed liability — as opposed to a deferred payment of cash by the Purchaser — would not come within the installment reporting rules. Second, it appears that the Service would contend for immediate rather than deferred income recognition.[90] Third, even if the income item is deferred, liability for tax is not, at least where the item is otherwise deductible, since there would be no liability for tax.

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89 To the extent the income element would be capital gain or Section 1231 gain, the taxpayer may be disadvantaged if it has otherwise unusable capital losses.

90 See the discussion at note 61, supra.

(ii) Purchaser

We think that a number of policy considerations support the treatment we have proposed for the Purchaser. We should emphasize, however, that the approach we recommend does not produce less revenue than would be derived if no sale of the business had occurred. (This point is examined in Part III.C., infra.) We think it appropriate to employ as a norm the income pattern that would have occurred in the absence of a sale.[91] Such an approach is not only consistent with commercial reality, but also with the Service's accepted treatment of business transfers between taxpayers in transactions governed by Section 351(a). (Although a carryover basis generally is provided in that case, a Section 351 transaction is not subject to Section 381, and the deduction carryover rules of Sections 381(c)(4) and (c)(16) were intentionally not made applicable to Section 351 transactions.[92])

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[91] As discussed in Part III.C.(iii), infra, the fact that a greater overall tax burden would generally be imposed if the Purchaser were required to capitalize its payments with respect to assumed liabilities does not establish a paradigm for taxing these transactions; it goes only to the proper timing of the Purchaser's deductions.

[92] S. Rep. No. 1622, 83d Cong., 2d Sess. 276.

Given this background, we think deductible treatment for the Purchaser is well-supported by the following considerations:

1. Contingent liability payments do not represent a cost of goodwill or going concern value. In an acquisition of a going business, it will often be the case that one or more fixed payments will be made for the tangible and identifiable intangible assets. As illustrated in greater detail in the Appendix to this Report, assuming that a bargain purchase has not been made, the result will often be that 100% of all payments in discharge of contingent liabilities will be treated as a cost of goodwill under the residual allocation rules applicable under Sections 338(h)(10) and 1060. We think such treatment is not correct, since the liabilities in fact represent ongoing costs that must be incurred to operate the business, and not the cost of the goodwill or going concern value associated with the business.

To illustrate, assume that five years following an acquisition, the Purchaser makes a payment of $100 on account of the current medical expense of A, a former employee of the business. Assume further that at the time of the acquisition, A had been employed in the business for 14 years. As discussed in greater detail below, some part of the $100 paid currently may be deemed to represent a liability that could have been estimated at the time of the acquisition using actuarial principles. It is submitted that such liability is not properly viewed as either cost of assuring continued patronage of the business, generally referred to as goodwill,[93] or as a cost of the intangible asset represented by the functioning assemblage of assets, etc. that constitutes going concern value.[94] Rather, it seems proper to view the expense as one whose chief value is continued sound relations with the company 's employees.

It is possible to argue that the problem identified here is a subset of a larger problem presented by the workings in tandem of the residual allocation rules and the present tax treatment of goodwill and going concern value. Initially, we would be inclined to identify the failing

[93] See In re Brown, 242 N.Y. 1 (1926).

[94] See VGS Corp. v. Commissioner, 68 T.C. 563 (1977) Acq., 1979-1 C.B.I.

in the latter rather than the former.[95] However, we do not believe that there is a need to address that much broader issue here. In our view, the often highly speculative nature of assumed contingent liabilities makes it quite difficult to link a payment made on account of the liability to any identifiable asset (tangible or intangible). Even where an actuarial estimate of the liability can be derived, we think (as discussed in greater detail in point 2., infra) it is more accurate to regard the expense as relating to the period in which it is incurred, rather than a longer or indefinite period of time.

2. The failure to provide deductible treatment for contingent liabilities results in a mismatching of income and expense. As an economic matter, the bundle of contingent liabilities and claims that accompany any operating business is counterbalanced by the stream of income generated by the business over time. For example, the cost of providing survivor's benefits to a spouse of a deceased employee offsets gross income from current production.

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95 The existing tax treatment of goodwill has, of course, been criticized by numerous commentators. See, e.g., Sheppard, Bank Deposits and the Mass Asset Rule, 41 Tax Notes 99 (October 3, 1988).

Although case authority such as Buten would mechanically allow or disallow the Purchaser's deduction for such expenses depending on whether the employee had retired at the time of the acquisition, we think such an approach elevates form over substance. Liabilities of this type simply do not lend themselves to classification as deductible or non-deductible to the Purchaser based on such elusive criteria as the status of the employee's retirement, illness, or the like on the date of the acquisition. Instead, we think such liabilities are more correctly regarded as offsets to the current earning power of the business, *i.e.*, "period" costs rather than capital expenses. As a result, in the typical situation in which the taxpayer's deductions relating to its costs in satisfying contingent liabilities are deferred or denied, there will occur a taxpayer-adverse mismatch. The desire to avoid such mismatching was a significant motivation of the Service in its rejection of Holdcroft in Revenue Rulings 80-198 and 83-155, *supra*, in the Section 351 setting.

3. Non-deductible treatment of contingent liabilities exacerbates the recognized problem of funding such liabilities. Various proposals relating to the funding of contingent liabilities such as retiree medical expense have been

made recently.[96] At the same time, the projected liability associated with such expenses and other expenses, such as environmental cleanup expenses has grown significantly, and there is continuing discussion as to the proper means to record such liabilities on corporate financial statements.[97] It must be recognized that to the extent businesses with major contingent liabilities are sold, denial or deferral of the deductions relating to the cost of meeting such liabilities will increase the private sector's cost of funding those liabilities.

4. It is difficult, if not impossible, to segregate "assumed" liabilities from those arising after the time of purchase. Webb, Pacific Transport and Holdcroft were not required to address the

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96 E.g., H.R. 1865, 101st Cong., 1st Sess. (1989); H.R. 1866, 101st Cong., 1st Sess. (1989). The bills provide mechanisms to pre-fund post-retirement health care and long-term care benefits on a tax deductible basis. One example of the type of relief that has been provided in a related area is the special rules for contributions to a trust to fund liabilities to past and present employees on account of pneumoconiosis (black lung disease). Section 192(a) provides a current deduction for contributions to a trust described in Section 501(c)(21) whose purpose is to fund the employer's liability with respect to such claims In the absence of the relief provided by this measure, no deduction would be permitted until the time of actual payment to the employee. See Section 461(h)(2)(C)(i).

97 See, e.g., Exposure Draft No. 078, Employer's Accounting for Postretirement Benefits other than Pensions (Fin. Accounting Standards Bd. 1989).

difficult questions of apportionment that will arise in virtually all taxable asset acquisitions if liabilities deemed "assumed" by the Purchaser are treated as non-deductible. In almost every business, retiree medical costs, environmental rehabilitation costs and the like represent a continuing cost of operating the business, making it difficult, if not impossible, to identify accurately the expenses attributable to the period before the acquisition. For some costs such as environmental rehabilitation expenses – which could relate to a 20- or 30-year period of pollution – it is difficult even to estimate the amount of the liability extant at the time of an acquisition. It is not unlikely that at the time of the acquisition, there will be no knowledge (or inadequate knowledge) of the liability, and claims will not come to light until many years later. The same could easily be true for products liability. As regards employee or retiree medical expenses, it will be extremely difficult to identify with any degree of certainty liabilities "assumed" in an acquisition when (i) the employee has not retired at the time of the acquisition, (ii) the employee has not developed any illness as of that time and (iii) no amount is required to be taken into account as regards such liability for financial accounting purposes. The fact that a liability arising prior to the acquisition may be totally indistinguishable from a later-arising liability of the same type (except by an arbitrary formula) suggests strongly that differing tax treatment for the two is inappropriate.

If one construes present law as broadly requiring capitalization with respect to assumed contingent liabilities, the question arises why there are no precedents dealing with the obviously intractable issues identified in the preceding paragraph. One can only ascribe this absence of authority to (i) aggressive return positions taken by taxpayers and (ii) failure of the Service to raise these issues on audit. If that is correct, the law effectively may be considered to reflect currently the approach we propose. We think this state of affairs is highly unsatisfactory. First, the approach penalizes taxpayers who attempt to self-assess their tax liability accurately and fairly. Second, the approach introduces needless risks and costs into sound business transactions, since the tax treatment of common business expenditures is not certain. Third, it seems plain that tax policy interests are not advanced to the extent that a tax reporting position at variance with reasonably clear precedent is widely taken, based only on a lack of audit surveillance.

5. Requiring capitalization of contingent liabilities leads to significant complexity. Although in many cases the payment of contingent liabilities will simply lead to increased basis in non-amortizable goodwill, there will also be many cases where the payment will be required to be allocated across numerous asset categories, including assets that have been disposed of and partially or fully depreciated. The Tax Court observed this complexity and pronounced it highly undesirable.[98] We would think the recent expressions of concern by the Service about the importance of administrability are relevant here as well.[99]

6. Asymmetrical treatment of Seller and Purchaser creates artificial impediments to taxable transfers of businesses. As discussed in greater detail in Part IV.B, infra, the application of the residual allocation rule under Section 338(h)(10)

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98 See Pacific Transport, supra note 36.

99 See, e.g., T.D. 8294, 55 Fed. Reg. 9463 (1990), and Treas. Reg. § 1.1502-20T, which broadly disallow losses on dispositions of stock of a subsidiary which is a member of an affiliated group filing a consolidated return.

or 1060, in conjunction with a generalized requirement of capitalization of payments with respect to assumed contingent liabilities, would generally result in either significant deferral or denial of the Purchaser's deductions relating to contingent liabilities. Indeed, non-deductibility often will occur if such payments are treated as a cost of goodwill. To the extent the Purchaser's deduction is deferred significantly or denied, a net tax burden will have been imposed between Seller and Purchaser merely by virtue of the transaction, and not in furtherance of any known tax policy objective. We think such treatment constitutes an improper impediment to business transfers that represent sound economic transactions.

C. Hypothetical Case

(i) Assumed Facts

The following is a simplified illustration of the tax consequences to the Seller and Purchaser under the approach we have recommended. S owns a business having a single asset with a tax basis of zero. If held, the asset would produce income of 15 per year for 3 years, at which time the asset would have no value. The business has a contingent liability (payment of which would be deductible); the liability is estimated to have a value of 10. It is assumed that the cash flows to be derived from the business have a net present value of 27, and that an arm's-length purchaser would buy the business for 21, the discount of 6 being intended to reflect P's profit on the transaction.[100]

If S continues to operate the business, it will realize gross income of 15 per year in years 1 through 3, which it will offset with a deduction of 10 in year 3, leaving aggregate taxable income of 35.

If, alternatively, S sells the business to P at the beginning of year 1 with P assuming the contingent liability, for a purchase price of 21, S will have immediate gain of 21. P will thereafter have gross income of 45, offset by cost recovery of 21, and, it is proposed, a deduction of 10 in year 3. Taken together, S and P have total taxable income of 35.[101]

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[100] A 15% discount rate has been employed.

[101] If the payment of 10 were included in P's tax basis for the acquired asset, the result would be the same only if P were given current asset basis (contrary to the rule of Albany Car Wheel, supra) or the period for depreciation or amortization were sufficiently short.

Finally, if S sells the business for 27 and retains the contingent liability, S will have immediate income of 27 and a year 3 deduction of 10, producing net income to S of 17. P will have gross income of 45 offset by cost recovery of 27, or net income of 18, and combined S-P taxable income will again be 35.

The following chart shows the pattern of income recognition under the three alternatives:

			Year 1	Year 2	Year 3
S retains Business	)	Income	15	15	15
	)	Expense	0	0	(10)
	)	Net	15	15	5
	)	Cumulative Net	15	30	35
Sale of business with assumption of liability	)	Income	36[102]	15	15
	)	Expense	(7) [103]	(7)	(17)[104]
	)	Net	29	8	(2)
	)	Cumulative Net	29	37	35
Sale of Business With liabili-lity retained	)	Income	42[105]	15	15
	)	Expense	(9) [106]	(9)	(19) [107]
	)	Net	33	6	(4)
		Cumulative Net	33	39	35

102 S amount realized of 21 plus P gross income of 15.

103 p cost recovery of 21 divided by 3 = 7.

104 p cost recovery of 7 plus P expense of 10.

105 S sale price for assets (27) plus P gross income of 15.

106 P cost recovery of 27 divided by 3 = 9.

107 P Cost recovery of 9 plus S expense of 10 = 19.

(ii) Neutrality of Suggested Approach

Two significant conclusions emerge from the foregoing example. First, there is no overstatement of deductions or net cost to the fisc of providing a deduction to the Purchaser at the time of payment of the assumed contingent liability.[108] This is true even when one considers that the Seller has been accorded a pseudo-deduction by not taking the assumption of the liability into income. There is no double deduction as between Seller and Purchaser because the assumed contingent liability is economically counterbalanced by an asset (approximately 7 worth of property) in which the Purchaser takes a zero basis.

[108] We recognize that greater revenue to the fisc will result in almost every case if the assumed liability is required to be capitalized. The point being made here is limited to the proposition that if one accepts that a general rule of Purchaser deductibility is proper from the standpoint of tax policy and administrability, the approach recommended results in no smaller revenue than if there had been no transfer of the business.

The Purchaser's deduction with respect to the liability is effectively eliminated by the income realized from the asset, with the result that a single true deduction is provided as between Seller and Purchaser.

The second conclusion is that there is no acceleration of deductions or deferral of income under an approach that allows the Purchaser to preserve the deductible character of the contingent liability. In fact, the converse is true: there is potential for acceleration of income since the Seller realizes inherent gain on the asset in year lf while the Purchaser's cost recovery is deferred. Note also that the most severe (and inappropriate) income acceleration occurs in the case where the liability is retained by the Seller — the situation where the parties might engage in self-help to avoid having the liability treated as a non-recoverable capital cost to the Purchaser.[109]

(iii) Issues Presented Regarding Suggested Approach

It has been suggested that the approach recommended' herein yields inappropriate results because (i) the Purchaser is effectively accorded

[109] Even more adverse tax treatment would arise if the deduction arises in a period when S does not have income from other sources, and its deductions cannot be carried back to a year in which it had income, or if S liquidates.

"step-in-the-shoes" treatment vis-à-vis the Seller, similar to that provided under Section 381(a) in the context of tax-free reorganizations and (ii) the fact of no increased tax burden between Seller and Purchaser is inconsistent with the tax treatment accorded to taxable sale transactions.[110]

With respect to the Section 381(a) analogy, the response is that the analogy is defective. In a Section 381(a) transaction, the Purchaser would indeed step into the Seller's shoes as regards the tax treatment of deductible items. At the same time, however, the Purchaser would take a carryover basis in the acquired assets.

Here, by contrast, the Purchaser would take a zero basis in so much of the acquired assets as relate to the contingent liability, such treatment assuring that no windfall tax benefit may accrue. Not only is the Section 381(a) analogy technically defective, it also misstates the substance of the proposal. It is the nature of Section 381(a) treatment to regard the purchasing

[110] 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). The article summarizes and comments on the above example and related analysis that were developed in the. preparation of Part III.C. of this report.

entity as a continuation of the selling entity. The approach we recommend differs fundamentally in that it accords independent treatment to Seller and Purchaser for the purpose of correctly assessing their separate incomes: the Seller is accorded a pseudo-deduction for the assumed liability because it has paid the liability under the reasoning of Commercial Security Bank; the Purchaser is accorded a deduction because, among other things, the expense is properly viewed as a period cost.

The argument that a higher combined tax burden should arise between Purchaser and Seller when a business is sold suffers from a similar deficiency. Clearly, the notion -of a greater tax burden incident to a sale is an observation of empirical fact, not a paradigm. A correct analysis of the tax burden of Seller and Purchaser in a taxable transaction must look to the accurate measurement of the separate income of each. For the Seller, we think providing a pseudo-deduction for the amount of the assumed liability correctly reflects the Seller's joint accretion to wealth and concomitant expenditure of assets. As regards the Purchaser, both the model that we propose and a capitalization approach afford cost recovery to the Purchaser with respect to its expense; the sole difference — but a critical one — is that of the timing of the Purchaser's recovery. As indicated, we think the Purchaser's income is more accurately measured by regarding the expenses in question as period costs.

D. Section 461(h) and 404 Policy Considerations

The foregoing analysis in Part III.C. also confirms that our suggested approach does not contravene the deduction limitation policies underlying Sections 461(h) or 404.

To the extent the liability is one to which Section 46.1(h) applies, we think that the approach we recommend satisfies the policy underlying that section as regards both Seller and Purchaser.

The Congressional purpose in enacting Section 461(h) was to prevent the overstatement of deductions which occurs when a deduction is claimed significantly in advance of the time that funds are expended or economic performance otherwise occurs.[111] It is clear that the Purchaser's deduction does not contravene the policy of Section. 461(h), since under the suggested approach the Purchaser would obtain a deduction only at such time as economic performance occurs — P's payment of 10

[111] Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 260-61 (1984) ("1984 Bluebook").

in cash in the example outlined above. Does S's implicit deduction in a prior year contravene the policy of Section 461(h)? In recently-proposed Regulation § 1.461-4(g)(l)(ii), the Service concluded that it does not, and we agree for two reasons.[112] First, S's deduction is off-set by the correlative income item that results when P takes a zero basis in the asset that "funds" the liability. Thus, S's deduction serves to prevent too much income from arising in the system."[113] Second, if S's deduction is for any reason considered overstated, so too will be the income from assumption of the liability; by definition, the two will always net to zero.[114] It seems reasonably clear that the policy underlying

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[112] Although, as discussed in note 30, supra, the proposed regulation would not provide a deduction to the Seller where the assumed liability does not satisfy the all-events test, it seems appropriate to regard that limitation as a technical shortcoming of the regulations.

[113] As noted above, S's deduction is also appropriate as to S standing alone, since the income recognized by assumption of the liability is offset by the expense deemed paid by S, under the analysis of Pierce and Commercial Security Bank.

[114] The character of the deduction and income items generally should not be of concern, since the expense will usually be ordinary and the income capital. See Part III.B.(i), supra.

Section 461(h) does not demand deferral of the deduction to the point of payment, only that the deduction not be overstated.[115]

Section 404(a) permits a deduction for payments to a qualified pension or profit sharing plan only in the year that payment to the plan occurs, with a grace period generally corresponding to the period for filing the payer's tax return. In the case of liability pursuant to a non-qualified deferred compensation plan the deduction is correlated with the employee's inclusion in income.[116] As regards the requirement of payment for deduction of qualified plan contributions, the rule conditioning deductibility on payment is designed to ensure that an employer deduction is allowed only where employees derive the intended benefit.[117] A desire to "match" the timing of the payor's deduction and the recipient's income explains the rule in the non-qualified plan context.[118]

115 1984 Bluebook at 261 (indicating that a deduction equal in value to the present value of a future cost- was appropriate from a policy viewpoint; but rejecting a discounting approach as unadministrable).

116 Section 83(h).

117 Don E. Williams Co. v. Commissioner, 429 U.S. 569, 578-79 (1977); David R. Webb Co. v. Commissioner, 708 F.2d at 1256.

118 1984 Bluebook at 804.

The principles discussed above with respect to Section 461(h) should be equally applicable as regards Section 404, both in the qualified and non-qualified plan contexts.

As a threshold matter, the factual situation in Webb should be distinguished from that usually involved when an ongoing qualified defined benefit employee pension plan is "assumed" by a purchaser of assets.

In Webb, there was no doubt as to the existence of a liability to make payments to the widow for as long as she lived. A primary issue in Webb was, thus, whether or not o measure that existing liability on an actuarial basis (the applicability of such a measure to a single life being coincidental) or to "wait and see" what occurred in the particular case. A secondary issue, if a "wait and see" approach were followed, is whether or not to allow a deduction as payments are made, rather than readjusting basis, in the interests of. administrative convenience in a manner akin to Associated Patentees . In Webb, the Tax Court, affirmed by the Circuit Court, adopted the "wait and see" approach and required piecemeal additions to basis.

In contrast to the facts in Webb, it is customary in a qualified defined benefit pension plan for the employer to limit its contractual liability to (i) payment of a set amount not actuarially determined (e.g., l0¢ per hour worked in the covered bargaining unit), or (ii) payment of amounts sufficient to maintain the plan in a "sound actuarial condition" or (iii) payment of amounts sufficient to prevent an accumulated funding deficiency from arising under Section 412. Agreement (i) is common in a multiemployer plan situation; agreement (ii) or (iii) is usual in a single employer defined benefit plan context. In the usual ongoing defined benefit qualified plan situation, unlike Webb there is no liability on the part of the employer to pay pensions at all. Delinquent contributions are, of course, fixed liabilities but these amounts, if any, are likely to be relatively small.

When an acquiring corporation "assumes" a target's ongoing qualified defined benefit pension plan, the transaction in fact involves the substitution of the new employer for the old employer with all rights of the old employer under the plan, including, in the case of a single employer plan, the right to terminate the plan. In the usual ongoing qualified defined benefit single employer plan assumption situation, no liability, contingent or fixed, is assumed by the acquiring corporation; but rather the acquiring corporation is substituted for the target corporation, for all plan purposes.

Since 1974 when the Employee Retirement Income Security Act was enacted, an employer under an ongoing single employer qualified defined benefit employee pension plan does have a statutory contingent liability to reimburse the Pension Benefit Guarantee Corporation for its cost of providing guaranteed benefits if the plan terminates in an underfunded condition. The multiemployer plan rules with respect to targetacquiror transfers of participation are complex, but their basic thrust is to impose liability on the target for a share of unfunded liabilities unless the acquiring corporation steps into the shoes of the target and maintains the plan as the target would have for at least five full plan years.

Because, in both the single employer and multiemployer plan situations, plan termination-triggered statutory liabilities are avoidable by the acquiring corporation's continuing to maintain the plan in normal business fashion, such liabilities should not ordinarily be treated as contingent liabilities of the target assumed by the acquiring corporation.[119] If the plan were underfunded and ripe for termination at the date of transfer, different treatment might be called for but such a situation would be unusual.

In the context of Section 404 outside the assumption of qualified employee pension plans, we also think our recommended rule does no violence to the principles underlying Section 404. The Purchaser's deduction continues to be conditioned on its satisfying the actual payment requirement. Although the Seller's pseudo-deduction is not subject to an actual payment requirement, it need not be, since the effect of this treatment of the Seller is only to shift the deductibility potential to the Purchaser. This approach appropriately provides the sanction of non-deductibility to the Purchaser, who is in a position to effect the payment. Moreover, it would be inappropriate to deny (or defer) the Seller's pseudo-deduction, since, as noted, it is not a true deduction, and thus need not be matched by a plan contribution or employee recognition of income.

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[119] This analysis is consistent with the approach taken by the Service. See G.C.M. 39274, supra note 84.

E. Disguised Purchase Price Considerations

The approach we recommend has the effect of providing dissimilar treatment of contingent purchase price obligations, on the one hand, and assumed contingent liabilities, on the other. We are not troubled by this dissimilarity, for two reasons: First, we do not believe the same tax treatment is appropriate for purchase price payments — which are capital by nature — and contingent liabilities which in our view represent ongoing expenses of the business that by their nature are deductible. Second, although there may be a theoretical concern that taxpayers will be able to obtain undue advantages by disguising purchase price payments as contingent liabilities, we believe it would be a relatively simple matter to prevent such mischaracterizations.

As regards the propriety of capital treatment for contingent purchase price payments, and the proposed deductible treatment for contingent liabilities of a deductible nature, we think the factors adverted to in Part III.B.(ii), supra, adequately distinguish the two: (i) Capital expenditures, including purchase price payments, are not (and should not be) deductible by the Purchaser. This principle holds true where expenditures (e.g., for plant or equipment) are incurred by the

Seller immediately prior to the acquisition. Thus, there is generally no asymmetry in the treatment of these costs between Seller and Purchaser.[120]

Authorities such as Pacific Transport and Holdcroft (prior to its limitation under Revenue Rulings 80-198 and 83-155) apparently would create differing treatment as between Seller and Purchaser for contingent liabilities. We think this distinction serves no policy objective. (ii) While contingent purchase price payments often may represent the cost of goodwill or going concern value, especially where they are linked to post-acquisition profitability, as discussed, contingent liabilities encumbering a business do not generally represent a cost of goodwill, going concern (or any other asset), (iii) The concern of mismatching income and expenses is present only as regards contingent liabilities. As discussed, expenses that are contingent (e.g., retiree medical expense, environmental rehabilitation expense) generally will represent ongoing costs of operating a business just like wages and periodic repairs to plant and equipment. The same is not

[120] An exception is the Seller's cost of building goodwill through advertising expense in contrast to the non-amortizable treatment that is accorded to purchased goodwill. See Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179 (1987).

true of amounts paid for the tangible and intangible assets of a business, (iv) Public policy concerns relating to funding important contingent liability items have no application in the contingent purchase price setting. (v) There is no difficulty in segregating purchase price payments from later arising expenses; a purchase price payment is identifiable as such.

As regards the need for a prophylactic rule, we think it will be sufficient to provide deductible treatment for a contingent liability only where the liability is related to a going business that is being transferred.[121] We think it will generally be apparent when parties attempt to introduce an unrelated contingent liability as a surrogate for purchase price, or when the transfer does not consist of the assets of a going business.

F. Section 338

Our proposal works easily in the context of Section 338 and Section 338(h)(10). The deemed Seller of old target would simply disregard deductible contingent liabilities in computing MADSP; and the deemed purchaser

[121] Compare Proposed Treas. Reg. § 1.461-4(g)(2).

of the new target would deduct such amounts when the applicable tax accounting standards are satisfied.[122]

Obviously, we would recommend that the apparent approach of the TAM 8741001, supra note 7, be rejected. Not only is it in conflict with the approach we recommend for the Purchaser; but its holding of income without deduction for the Seller rather plainly conflicts with clear precedent.[123]

IV. Additional Issues Relating to Approaches Rejected

We note here some additional considerations relating to the approaches we have rejected for the treatment of the Purchaser. First/ as regards the possibility of creating income to the Purchaser, we find no merit in this approach from a policy standpoint, and also significant practical difficulties . As regards the capitalization approach of Webb and Pacific Transport, we identify what we think are significant shortcomings in the treatment of contingent liabilities under

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[122] See footnote 87, supra, regarding the treatment of non-deductible liabilities.

[123] The TAM's stated inability to find authority for an offsetting deduction to the Seller in Treas. Reg. § 1.338(b)- 3T(h)(l)(i) also appears incorrect in light of the last sentence of the regulation, which clearly contemplates that later income items may be accompanied by correlative effects.

the residual allocation rules applicable in Section 338(h)(10) and 1060 transactions.

(i) Purchaser Charged with Income

As discussed in Part II.B.(ii), supra, the notion that a Purchaser might be charged with income for having assumed a contingent liability derives from the Pierce case, which created a deduction to the Seller by reason of the assumption of a deductible liability; and supported that holding through the fiction that the Seller had made a payment to the Purchaser. As discussed, this approach also gives the Purchaser tax basis in the acquired assets equal to the assumed liability, and a deduction for the amount paid when the liability ultimately is discharged. We find this approach troublesome both at a conceptual and practical level.

In essence this approach views the Purchaser as an insurer, and requires him to record income, apparently under the rationale of Schlude v. Commissioner[124] and American Auto- mobile Ass'n v. United States[125] for the payment deemed made by the Seller.

[124] 372 U.S. 128 (1963).

[125] 367 U.S. 687 (1961).

At a conceptual level, a requirement of income recognition is improper since the Purchaser has no accretion to net worth. Its 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. This same logic has long prevented a borrower under a debt instrument from recognizing income.[126] Moreover, there does not appear to be any other policy basis for charging the Purchaser with income. As demonstrated in Part III.C., supra, no income escapes taxation by reason of failure to charge the Purchaser with income.

At a practical level, the obvious deficiency in this approach is the inability in many cases to quantify the income inclusion with even a modicum of precision. Since the liability is, by definition, contingent, disputes over the amount ultimately to be paid and the appropriate discount rate will be constant. Moreover, the equivalence of the income amount and tax basis in the acquired assets do not assure tax neutrality; in virtually all cases, the year 1 income inclusion will be more costly than the expected cost recovery. It is not sound to burden the tax system with open-ended valuation

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[126] IB. Bittker & L. Lokken, Federal Income Taxation of Income, Estates and Gifts t 6.1 (2d ed. 1989).

issues such as that presented here in the absence of a compelling policy justification.

(ii) Valuing Assumed Contingent Liabilities

We note here the possibility of adopting an approach as regards the Purchaser that would place a value on the assumed contingent liability at the time of the acquisition. The tax treatment of the Purchaser would then be as follows:

> (i) The amount of the liability would be included in the tax basis of the acquired assets in the same manner as a fixed liability.
>
> (ii) Upon satisfaction of the liability, (a) if the amount paid exceeds the acquisition date value, such excess would be deductible at the time paid and (b) if the amount paid is less than the acquisition date value, the shortfall would be required to be included in income.

The Seller's tax treatment would not be changed from that described in .Part III, supra.

Favoring this approach is that it may correspond to the actual economic analysis made by the Purchaser.

This approach is similar to that utilized for financial statement purposes.[127]

Militating against this approach, however, is the overwhelming administrative concern presented by the need to establish a value for all contingent liabilities assumed in acquisitions. While in some cases parties to the transaction will identify such liabilities in the documentation of the sale, this will perhaps just as frequently not be the case. Moreover, many liabilities will not have assigned an agreed value; and there will be no balance sheet entry to reflect the liability. Compounding the difficulty would be Purchasers' general bias to minimize liabilities, so as to capitalize as little as possible and to deduct currently as much as possible upon payment of the liability. The Service generally would have the opposite incentive, to identify otherwise unknown liabilities and exposures, and maximize

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[127] under Business Combinations, APB Opinion No. 16 (Am. Inst. of Certified Pub. Accountants 1970), as amended by Accounting for Preacquisition Contingencies of Purchased Enterprises, Statement of Financial Accounting Standards No. 38 (Fin. Accounting Standards Bd. 1980), the present value of the liability is reflected as the cost of acquired assets, with differences between the amount initially determined and the amount finally paid being reflected in net income for the period in which the payment is finally made. (The FASB principles provide for an allocation period, generally one year, during which differences are reflected as a purchase price adjustment.)

the amount thereof. We think the factual issues presented by this approach render it unworkable as a practical matter, notwithstanding the theoretical appeal of the approach. Intractable valuation issues could be expected to arise in every major acquistion; obviously, the presence of such issues would involve significant cost and expense for both the Service and taxpayers. The issues would be especially difficult since in many (if not most) cases, the parties will not have agreed on the amount of the liability for any business or tax purpose. (Moreover, an agreement between Seller and Purchaser would be inherently suspect since the Seller would have no tax motivation in agreeing on the amount of the liability; since the income arising on assumption of the liability would in the case in question be offset by a deduction for the expense.) In short, we think the pervasive administrative concerns render this approach impractical.

Appendix

Operation of Residual Allocation Rule

As discussed in Part II.B.(iii) of this Report, Purchasers in Sections 338(h)(10) and 1060 transactions are required to employ a residual allocation approach in allocating revised AGUE and adjusted purchase consideration, respectively, when a contingent liability becomes fixed. To the extent that are rendered non-recoverable for tax purposes as the cost of goodwill.[128]

To illustrate, assume a business has two assets, a machine and accounts receivable, each worth 50. The business is bought for 70 of cash plus assumption of a contingent liability estimated to have a value of 30. In fact, the liability is satisfied for 30 in year 4. The Purchaser is initially required to allocate 35 to the receivables and 35 to the machine (i.e., the fixed purchase price payment). The result is that the Purchaser will recognize 15 of gain when it collects the receivables in year 1. (The payment of the contingent liability would apparently yield a current deduction of 15 in year 4, based on a 50% allocation to the receivables, and deferred recovery of the other 15 depending on the useful life of the machine.)[129]

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128 See generally, Schler, supra note 61.

129 See Proposed Treas. Reg. S 1. 168-2 (d) (3) , under hich depreciation deductions related to additional purchase price arising from contingent purchase price payments are computed. The proposed regulations require that the recovery property's unadjusted basis be redetermined to include the contingent payments, then reduced by the recovery allowance previously allowed. The recovery percentage is then determined by dividing the otherwise applicable percentage by an amount equal to 100 minus the percentages for previous recovery years.

Assume alternatively that the receivables are worth 60, but that the machine is valued at 10. Since the allocation of 70 (the fixed purchase price payment) to the machine and receivables is equal to the full fair market value of the Class III assets (there being no Class I or II assets), all amounts paid on account of the contingent liability will be allocated to goodwill. This approach creates results bordering on the absurd where the assumed contingent liability greatly exceeds the Purchaser's (and perhaps the Seller's) expectations. For example, in Pacific Transport,[130] the assumed liability was greatly in excess of that expected by the Purchaser, following reversal of a prior Circuit Court decision. Although the significant additional expenditures related to nothing other than a faulty estimation of the amount of the liability, the residual allocation rule would frequently classify the expense as non-deductible goodwill.

In summary, the existing residual allocation rules will in virtually all cases produce either significant deferral or complete elimination of deductions relating to contingent liabilities.

[130] Discussed supra at notes 36-43