Contingent Liabilities in Taxable Transactions and Distributions

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Introduction
Definition of Contingent Liability

• Accrual basis taxpayer (I.R.C. §461(h)):
  – “All events” have occurred which determine the fact of the liability (“fixed”),
    the amount of the liability can be determined with reasonable accuracy
    (“determinable”), and
  – “Economic performance” has occurred.

• Cash basis taxpayer
  – taken in account when paid (other than certain pre-payments)

• Contingent liability vs. Asset “defect”
Whether Liability is an Assumed Liability

-- Assumption Factors

1. Buyer’s operations
   • Activity performed by the buyer
   • Events under the buyer’s control
   • Liability arising from buyers decision
   • Goal is to separate the occurrence of the liability from the seller and the acquisition (i.e., not a seller liability)
   • If it does not relate to the seller’s operation of the business, then the Buyer can deduct the payment
     • *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946)
     • *Albany Car Wheel v. Commissioner*, 333 F.2d 653 (2nd Cir. 1964) (liability arose after acquisition due to buyer’s decision to close plant)
     • TAM 9721002 – acquisition and severance pay
     • *Illinois Tool Works v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
Whether Liability is an Assumed Liability
-- Assumption Factors

2. Where liability arises post-acquisition
   • For example, certain employee benefit cases
     – Where there is a contract in place at the time of the acquisition to pay death benefits when an employee dies
     – If employee dies after closing, then the liability should be a buyer liability
     – Even though contract in place, it’s contingent because you know he will die eventually
   • If employee has already died and seller is obligated to pay, the buyer assumes the obligation—No deduction.

   • *M. Buten & Sons, Inc. v. Commissioner*, 31 T.C.M. (CCH) 178 (1972)
   • *David R. Webb Company, Inc. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983)
Whether Liability is an Assumed Liability
-- Assumption Factors

3. Whether the buyer was aware of the liability
   • If buyer is aware of the claim at the time of the acquisition, there is no deduction for payment of the claim but if buyer unaware, buyer may be able to deduct the liability
   • *Pacific Transport v. Commissioner*, 29 T.C.M. 133 (1970), rev’d per curiam 483 F.2d 209 (9th Cir. 1973)
   • *But see Holdcroft.* Court might not care whether the buyer knew of the liability and may instead look to when the liability arose. If the liability relates to the seller, then no deduction. *See Illinois Tool Works v. Commissioner*, 117 T.C. 39 (2001), aff’d 355 F.3d 997 (7th Cir. 2004).
Whether Liability is an Assumed Liability
-- Assumption Factors

4. Liability timing

• This factor can be used to explain the tort cases. Courts have stated that legal liability for a tort arises when the tort occurs.
  – Using this factor would lead a court to conclude that a pre-closing cause of action is a liability of the seller. If the buyer pays the liability, there is no deduction.
  – *Holdcroft* and *Pacific Transport* support the notion that the contingent nature of the tort is not relevant

• Compare this result to the contract cases where the liability represents a contractual claim, not a tort.

• *Albany Car Wheel Co.*
Whether Liability is an Assumed Liability

-- Assumption Factors

5. Whether the contingent liability is reflected in the price

• If the purchase price was reduced, then the liability looks like an assumed liability

• This factor comes up often where
  – Purchase price based on balance sheet
  – Reserve on balance sheet (e.g., for employee medical benefits)

• Allows IRS to argue that the liability was reflected in the price
Whether Liability is an Assumed Liability

--- Assumption Factors

6. Buyer’s express assumption

- If the buyer expressly assumes a liability of the seller, courts generally conclude that the buyer is assuming the liability.

- However, this factor alone is not fatal. In *Albany Car Wheel* the buyer expressly assumed a collective bargaining liability (severance pay in the event of a plant shutdown). However, the court said that the liability in fact was assumed.
Assumptions of Contingent Liabilities in Taxable Asset Acquisitions
Assumptions in Taxable Transactions
-- Seller Treatment

- Relief of liabilities is included in amount realized on sale or exchange of property. See 1.1001-2(a)(1).

- Contingent liabilities lacking only economic performance
  - In connection with the sale of a business, if purchaser “expressly assumes” liabilities arising out of business that would be incurred “but for” economic performance, then economic performances is deemed to occur when the liability assumption is included in amount realized. See 1.461-4(d)(5)(i).

- Contingent liabilities lacking “all events” likely not included in amount realized. [Cf Holdcroft (post-closing events gave rise to deduction).]
Assumptions in Taxable Transactions
-- Seller Treatment

• Contingent liabilities lacking fixed amount raise questions as to timing and amount of inclusion:
  – Value at closing, include at closing? or
  – Value once fixed, include once fixed?

• Does relief of the liability give rise to a deduction at closing? Once fixed?
Assumptions in Taxable Transactions

-- Seller Treatment

Example of assumed non-fixed contingent liability

• In Year 1, S sells its business to P. The assets of the business include an office building located on contaminated land. No further contamination is continuing. The cost to remediate the land is unknown but is estimated by S and P to equal $20X.

• In Year 3, P settles the environmental remediation obligation for $50X.
  – Does S include $20X in amount realized in Year 1? If so, can S deduct (or capitalize) the remediation expense? If not, can it do so in Year 3?
  – Does S include $50X in amount realized in Year 3? Can S deduct (or capitalize) the remediation expense?
Assumptions in Taxable Transactions -- Seller Treatment

Assumed liabilities lacking reasonable measurement

• Examples
  – Environmental claims
  – Product liability claims
  – Deferred revenue (see James M. Pierce, 326 F.2d 67 (8th Cir. 1964); Rev. Rul. 68-112)
  – Unfunded deferred compensation (see Section 404(a)(5); TAM 8939002 (June 15, 1989))
  – Unfunded qualified pension liability (David Webb, 708 F.2d 1254 (7th Cir. 1983); G.C.M. 39274)
  – Retiree medical
Assumptions in Taxable Transactions
-- Seller Treatment

Installment Sale Issues

• Section 453 generally permits reporting gain on the installment method if at least 1 payment is received in a year of the seller after the year of sale.
  – If contingent liabilities are taken into account under the “wait and see” approach and liabilities are included in amount realized, is the assumption of contingent liabilities (constituting qualifying indebtedness) eligible for the installment method? Cf. Treas. Reg. §15a.453-1(b)(2)(iii). If so, how is basis recovered? See, e.g., Treas. Reg. §15a.453-1(c)(7 ) (basis recovery with neither maximum price nor maximum term)
  – If these are not taken into account under the installment method, are contingent liabilities under a “wait and see” treated like other liabilities assumed; generally increasing the gross profit ratio? See Treas. Reg. §15a.453-1(b)(2)(i).
  – Burnet v. Logan, 283 U.S. 404 (1931) – are these circumstances “rare and unusual”? 
Contingent Liabilities

-- Buyer Treatment

Basis

• Treat liability as cost of the assets.

• Add to the assets’ basis when the liability becomes fixed, determinable, and economic performance satisfied.

• Capitalization approach has the greatest support in the case law
  – See *Webb v. Commissioner*, 77 T.C. 1134 (1981), aff’d, 708 F.2d 1254 (7th Cir. 1983). Unfunded pension liability assumed in asset acquisition; payments treated as cost of acquired assets
    – See also *Holdcroft, Pacific Transport, M. Buten & Sons*.

• Uncertain whether buyer can treat a portion of the payments as interest
Contingent Liabilities

--- *Buyer Treatment*

**Deduction**

- Buyer gets a deduction when the liability is fixed
- *Albany Car Wheel*, 333 F.2d 653 (2d Cir. 1964)
  - Agreement specifically said liability to pay severance in the event of a plant shutdown was assumed
  - But court said that facts showed that the liability was not assumed and the buyer had made a decision that resulted in the liability to pay severance (i.e., shutting down the plant).
- *United States v. Minneapolis and St. Louis Railway Co.*, 260 F.3d 663 (8th Cir. 1958)
  - Suggests deductibility method but can also be read as saying nothing was assumed
- *F&D Rentals, Inc.*, 365 F.2d 64 (7th Cir. 1966)
  - Court said in dicta that taxpayer could deduct if payment had been made
Assumptions in Section 301 Distributions and Section 331/336 Liquidations
Assumptions in Distributions
-- *Distributing Corporation Treatment*

**Effect on transfer of assets**

- No effect on gain recognized under 311(b) or gain or loss recognized under 336
  - Gain (or loss) is recognized based on asset fmv.
- But see 311(b)(2) and 336 (b) (asset fmv is not less than amount of liabilities assumed)
  - Query whether assumed contingent liabilities included in 311(b)(2) and 336(b) determination
  - Query effect if amount of liability once fixed, determinable and economic performance satisfied is different from amount in initial determination

**Deductibility**

- Pre-General Utilities repeal authorities do not permit deduction.
  - See Rev. Rul. 59-228, Arcade Restaurants 7 TCM 563 (1948), GCM 38,271
- Query whether gain recognition/deemed sale model of 311(b) and 336(a) militate for deductibility
Assumptions in Distributions
-- Distributee Treatment

Effect on transfer of assets

- No effect on basis of assets received under 301(d) and 334(a)
  - Basis is determined by reference to asset fmv

Deductibility

- No deduction allowed. Sole effect is to reduce amount of distribution. Rev. Rul. 72-137. See also GCM 38271 (“Consequently, since no payment or adjustment is specifically made here as compensation for liability assumption, since no payment or adjustment is justified, and since none is required, we believe it improper to treat one as having been effected.”)
Assumptions in Distributions
-- Distributee Treatment

Effect on amount of distribution

- Reduces amount of distribution under 301(b)(2)
  - 1.301-1(g) requires that liability be assumed within meaning of 357(d)
- For 331 liquidations, assumed liability be “known” at time of distribution. Rev. Rul. 72-137
  - Query whether this is an accrual “fixed and determinable” standard. Query also whether economic performance must be satisfied at time of distribution. Rev. Rul. 59-228 allows reduction for present value of a future liability.
- For 331 liquidations, distributee allowed a capital loss in year liability becomes fixed, determinable and economic performance satisfied to extent liability did not previously reduce amount of distribution. Rev. Rul. 72-137.
- Query whether similar principles apply for 301 distributions. Since 301 is to determine economic benefit to shareholders, perhaps assumed contingent liabilities should reduce amount of distribution at time of distribution.
Assumptions in Section 304 Transactions
Assumptions in Section 304 Transactions

--- **Transferor Corporation Treatment**

**Effect on amount of distribution**

- Query whether 357(c) has any relevance for whether assumption of a contingent liability should be taken into account under 304

- **Maher** indicates no dividend to transferor at time of assumption when transferor remains secondarily liable because economic benefit to transferor is “too speculative”
  - Query whether incorporation of section 357(d) principles into 301 under 1.301-1(g) for assumptions flowing in opposite direction suggest a different answer
  - Query whether contingent liabilities for which transferor does not retain secondary liability are also “too speculative”

- If assumption of contingent liability results in distribution of some amount at time of assumption, query result when assumed liability once fixed, determinable, and economic performance satisfied differs in amount. Can there be increases or decreases to the amount of the distribution at the later date.