ASSUMED CONTINGENT LIABILITIES IN ASSET ACQUISITIONS — NEW TAX COURT CASE

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This article examines a Tax Court decision concerning the treatment to a seller of assets where the buyer assumes a contingent liability associated with the business.

Introduction

In *Hoops*,[1] the Tax Court recently addressed a longstanding, unanswered issue: what is the treatment to a seller of assets, where the buyer assumes a contingent liability associated with the business? While the treatment of such assumed obligations to the *purchaser* of assets is well known,[2] *Hoops* is one of the few cases that address the *seller*'s treatment. The last case to address this issue comprehensively arose prior to the Tax Reform Act of 1986 when old Section 337 allowed a C Corporation seller to dispose of assets without recognition of gain. A lot has changed since then.

The result in *Hoops* was that the seller was required to include the fair market value of deferred compensation liabilities in taxable proceeds without an offsetting deduction during the year at issue before the court.[3] The implications of this decision and such a mismatch in timing are significant for any asset sale involving assumed contingent liabilities, including actual asset sales, deemed asset sales by operation of Section 338(h)(10), or as will be seen in a recent Technical Advice Memorandum ("TAM"), internal transactions such as liquidations of insolvent subsidiaries.[4]

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General background on assumed contingent liabilities

The treatment of contingent liabilities in acquisitions first requires a definition of the term "contingent liability." A "contingent liability" refers to an obligation that has not yet ripened into a deduction or basis for tax purposes under Section 461 or Section 1012 of the Code. Such a liability may be recognized by the parties to the transaction as having real economic value and also may be reflected in a reserve on the financial statements in accordance with generally accepted accounting principles.

However, under U.S. tax accounting rules, a liability of an accrual method taxpayer is only incurred as a deduction or capitalized cost if it satisfies the three-pronged all-events test of Section 461 and the regulations thereunder.[5] First, all facts must have occurred to cause the existence of the liability to be fixed. Second, the amount of the liability must be determinable with reasonable accuracy. Third, economic performance must have occurred with respect to the liability. Depending on the nature of the liability, economic performance may require, for example, that goods or services giving rise to the liability be delivered or in some cases, that payment be made to a third party.[6]

In addition to the three-pronged all-events test, other statutory provisions may defer accrued expenses from being taken into account as a deduction, such as Section 404(a)(5), the provision at issue in *Hoops.*

It is well-established that the purchaser of assets is required to capitalize assumed liabilities of the seller into the cost basis of the property acquired under Section 1012. This includes contingent liabilities of the business that are properly considered to have arisen prior to closing.[7]

Whether a contingent liability is a liability of the seller that must be capitalized or a liability of the buyer that may be deducted in the course of its post-closing operations is a fact-specific, case law inquiry. While the courts have considered a number of different factors, the Service has summarized the case law as providing that "capitalization is required where the events most crucial to creation of the obligation occur before the acquisition, while deduction is allowed where the events most crucial to creation of the obligation occur after the acquisition."[8]

On the seller side of the equation, there is a paucity of case law concerning the treatment of particular types of contingent liabilities or even laying out a basic framework for analysis. It is well settled that a seller must include in amount realized the amount of any indebtedness or liabilities assumed by the buyer to the extent those liabilities have given rise to a deduction or tax basis.[9] This treatment is self-evident: where the seller has achieved a tax benefit from the liability that benefit must be reversed out through gain or income when the liability is assumed; otherwise, the seller could achieve a different result by selling assets subject to a liability from selling assets for increased cash and using the cash to retire the liability.

With contingent liabilities, however, the treatment to the seller raises more difficult questions. On some level, a contingent obligation assumed by the buyer, particularly one reflected as a reserve on the financial statements, would seem to have economic value and cause the seller to receive a benefit as compared to selling the assets and retaining the liability. The assumption of such an obligation without an offsetting indemnity may in some cases reduce proceeds. However, from a tax accounting perspective, the liability has not yet, and may never, produce a tax benefit to the seller to be recaptured through additional gain.

The principles underlying Reg. 1.1001-2, as articulated in the bedrock cases of *Crane* and *Tufts*,[10] seem to be based on the seller recapturing a tax benefit of a prior loss or deduction that is then reversed out when the liability is discharged. If no deduction or expense for the liability has been taken by the seller, what tax benefit is the seller receiving when the liability is discharged? Moreover, if the seller is required to include the buyer's assumption of a contingent liability in proceeds, without being entitled to a deduction, the seller in some case is taxed on non-economic income. To the extent the correct answer is to treat the contingent liabilities both as proceeds and as an offsetting deduction, the issues of measuring the amount and timing of gain and offsetting deduction are difficult from both an economic and technical tax perspective.[11]

The fact pattern in *Hoops* required the court to provide partial answers in this difficult and long underexplored corner of M&A tax law. The Tax Court held that the taxpayer was required to increase gain by the estimated net

1 TCM 2022-9.

2 *See, e.g.*, *Illinois Tool Works, Inc.*, 355 F.3d 997 (7th Cir., 2004), *aff'g* 117 T.C. 39 (2001); *Amergen Energy Co., LLC*, 779 F.3d 1368 (Fed Cir., 2015), *aff'g* 113 Fed. Cl. 52 (2013).

3 Left unaddressed by the Tax Court's decision is whether the seller might be permitted to claim a tax deduction when the buyer satisfies the assumed obligation in a later taxable year, and if so, on what basis.

4 See TAM 202116062 (4/23/2021), discussed below.

5 Reg. 1.461-1(a)(2). In *Amergen Energy Co., LLC*, 779 F.3d 1368 (Fed Cir., 2015), *aff'g* 113 Fed. Cl. 52 (2013), addressing nuclear decommissioning costs, the Court of Claims and Federal Circuit both held that the three-part test of Section 461(h) also applies to a liability incurred as part of the cost basis for acquisition of capital assets. Likewise, liabilities are only capitalized into the tax basis of inventory under Section 263A if they satisfy the three prongs of the all-events test. See Regs. 1.263A-1(c)(2)(ii) and 1.446-1(c)(1)(ii)(B).

6 *See* Reg. 1.461-4.

7 For example, see the cases cited in Footnote 2 above.

8 PLR 201036009 (9/10/2010).

9 Reg. 1.1001-2(a)(1); *Crane*, 331 U.S. 1 (1947). Compare Reg. 1.1001-2(a)(3) (providing that a liability incurred on acquisition of property is not included in amount realized when it is assumed or discharged, if the liability did not give rise to basis in the acquired property).

10 *Tufts*, 461 U.S. 300 (1983).

11 In *Hoops*, the liabilities represented deferred compensation payments that were fixed in fact and amount, but subject to payment on a deferred schedule. Even this relatively fixed liability raised measurement issues. The opinion states that the taxpayer in *Hoops* applied a 3% discount rate of the future payments to determine the amount of the liability. Was this the right discount rate to use? If the seller were subsequently permitted a deduction when the liability is satisfied how should the parties account for the difference between the discounted net present value and the ultimate amount paid? In the case of longer-term liabilities, such as for nuclear decommissioning, the timing and measurement issues may prove to be intractable.

present value of the compensation liability. At the same time, the court rejected the taxpayer's reliance on Reg. 1.461-4(d)(5), discussed below, to claim an offsetting deduction in the same amount for the deemed satisfaction of the liability. Left unanswered by the decision was when, if ever, and in what amount, would the seller be permitted to claim an offsetting deduction for the deferred compensation liabilities assumed and later satisfied by the buyer.

Detailed case discussion and analysis

The transaction at issue in *Hoops* was a sale of assets constituting a National Basketball Association (NBA) franchise subject to various liabilities. Among the liabilities assumed was approximately $12.6 million of deferred compensation owing to two players for past services. Payment of the amounts was deferred according to a fixed schedule set under the terms of NBA player contracts.

The partnership in *Hoops* was an accrual method taxpayer. It had accrued the compensation as an expense under the all-events test and economic performance had been met (i.e., the liability related to services rendered in the past), but the deduction for the liability was deferred under Section 404(a)(5). That section provides that deductions for deferred compensation are generally deductible only in the employer's taxable year in which, or with which, ends the taxable year in which the employee includes the amounts in taxable income.[12]

As a practical matter, this section often causes deductions for deferred compensation to be taken into account on the cash method—i.e., when payments to the employee are made. As a result, the deferred compensation to the players was not deductible in the year of sale of the business. The buyer assumed the liabilities, and on payment of compensation, would generally be entitled to take the expense into account as part of the capitalized cost of acquiring the assets.[13]

On its tax return as filed, the seller included the net present value of the deferred compensation liabilities as part of its amount realized on the sale of assets.[14] The seller did not claim any offsetting deduction. On the amended return that ended up presented to the Tax Court for decision, the seller claimed an offsetting deduction in reliance on Reg. 1.461-4(d)(5). In the alternative, the seller argued that it was erroneous to include the assumption of the liability in proceeds when it had not been taken into account as a deduction or as basis in any assets.

Issued in the early 1990s, Reg. 1.461-4(d)(5) provides for matching treatment of certain contingent liabilities that are assumed as part of the sale of a trade or business, providing that economic performance is considered to be satisfied as the liability is taken into account as proceeds.[15] Note that the regulation does not state ***when** the liability should be taken into account as additional proceeds*; it only provides that economic performance is deemed to be satisfied in the same year as the liability is included in proceeds, so that an offsetting deduction may be claimed.

The result in *Hoops* was that the seller was required to include the fair market value of deferred compensation liabilities in taxable proceeds without an offsetting deduction during the year at issue before the court.

Reg. 1.461-4(d)(5), in effect, establishes a matching concept and prevents a whipsaw that might otherwise arise if accrued, but unperformed, liabilities were required to be taken into account in taxable proceeds in advance of the deduction arising.[16] Further, if the seller actually liquidated following the sale of assets, or under Section 338 was deemed to liquidate, the

[12] Section 404(a)(5); Reg. 1.404(a)-12(b)(1).

[13] Under the case law discussed above, liabilities arising out of pre-closing performance of services have been required to be capitalized by the buyer of assets. *See David R. Webb Co.*, 708 F.2d 1254 (7th Cir., 1983), *aff'g* 77 T.C. 1134 (1981); *M. Buten & Sons, Inc.*, TCM 1972-44; TAM 9721002 (1/24/1997).

[14] The seller was a partnership for U.S. federal income tax purposes, and reported the gain as subject to Section 1231, presumably giving rise to long-term capital gains. By including the liability in proceeds, the partnership increased its Section 1231 gain. To the extent that the seller was entitled to claim a deduction for the liability, this increased Section 1231 gain would have been offset by ordinary compensation expense, producing a favorable character result for the seller.

[15] The regulation requires that the buyer "expressly assume" the liabilities as part of the acquisition. A purchase of shares with a Section 338 election or similar transaction has been treated as an "express assumption" of liabilities for this purpose. *See, e.g.*, TAM 202116012.

[16] This timing mismatch could be particularly acute in the case of long-term liabilities of the type that gave rise to the economic performance requirement in the first place. *See Ford Motor Co.*, 71 F.3d 209 (6th Cir., 1995), affg 102 T.C. 87 (1994); *Mooney Aircraft, Inc.*, 420 F.2d 400 (5th Cir., 1969).

mismatch in timing could result in a permanent disallowance of the deduction. The regulation was intended in part to address these problems posed by the economic performance requirement.[17]

At the same time, however, Reg. 1.461-4(d)(5), by its literal terms, is limited to the economic performance requirement. Contingent liabilities that have not met the all-events test are not explicitly addressed. The portion of the regulation project from 1992 relating to "contingent liabilities" remains reserved for further guidance.[18]

In *Hoops*, the taxpayer, as noted above, relied on Reg. 1.461-4(d)(5) to permit the deferred compensation liabilities to be satisfied. The Tax Court rejected this position and held that Reg. 1.461-4(d)(5) only deemed economic performance to be satisfied. In the case of the compensation liabilities, it was not economic performance but rather Section 404(a)(5) that deferred the deduction. Although this led to an unfortunate whipsaw to the taxpayer, the court found that Reg. 1.461-4(d)(5) did not deem Section 404(a)(5) to be satisfied. The court also reasoned that such a result was required by the tax policies underlying Section 404(a)(5), which are discussed at length in the case.

The implications of *Hoops* and such a mismatch in timing are significant for any asset sale involving assumed contingent liabilities.

Alternatively, the taxpayer argued that, if the liabilities were not sufficiently ripe to be deductible, their assumption should not be included in gross proceeds. The Tax Court also rejected this position. On this point, the court stated that the parties agreed the players had performed the services, so that the taxpayer had an *obligation* to pay the compensation. Relying on *Commercial Security Bank*,[19] discussed at length below, the court held that this payment obligation was an assumed liability for purposes of Section 1001.

The court also rejected the taxpayer's arguments that the Section 1001 definition of "liability" should be consistent with that of other Code sections, such as Section 357(c), under which the case law has distinguished between deductible "liabilities" and unmatured "obligations."[20] Therefore, the partnership was left including the assumed liabilities in taxable proceeds without an offsetting deduction in the years before the court (or perhaps at any time).

Both conclusions of the court—i.e., that Reg. 1.461-4(d)(5) did not permit an offsetting deduction and the deferred compensation obligation was properly included in proceeds prior to being deducted—raise interesting issues and implications for planning.

The deduction aspect—what is the scope of Reg. 1.461-4(d)(5)?

In the primary issue addressed in the opinion, the Tax Court held that Reg. 1.461-4(d)(5) was limited to deeming economic performance to be satisfied, and therefore, did not satisfy the requirements for deductibility under Section 404(a)(5). The court stressed that the policy of Section 404(a)(5) could be thwarted by any other interpretation.

The decision in *Hoops* reaches a similar result to the Service's position expressed in Technical Advice Memorandum("TAM") 8939002 (6/15/1989). The TAM, notably, involved a sale of assets under Section 337 prior to repeal of the *General Utilities* doctrine. In the TAM, the taxpayer sold all of its assets in a taxable transaction and then liquidated. Pre-1986 Tax Reform Act law (i.e., old Section 337) applied to provide non-recognition treatment to the taxpayer's gain realized on its sale of assets. Therefore, whether the liability assumed by the buyer was part of proceeds or not, such gain was not recognized by the corporate seller.

As part of the asset sale in liquidation of the seller, the buyer assumed the obligation to pay deferred compensation. Relying on *Commercial Security Bank*, the taxpayer argued that by accepting less proceeds, it had constructively satisfied the liabilities and therefore, was entitled to a deduction. The taxpayer also invoked the analysis of *James M. Pierce Corp.*,[21] arguing that it had secured a deduction apart from payment of the service providers by paying the buyer to assume the liability. The Service rejected both arguments, and in the TAM advised that Section 404(a)(5) conditions the deduction on income inclusion by the payee, not assumption or discharge of the liability of the payor.

[17] *See* T.D. 8408, 1992-1 C.B. 155, 160 (4/9/1992).

[18] *See* Reg. 1.461-4(j).

[19] 77 T.C. 145, 148–49 (1981).

[20] Specifically, the taxpayer cited *Focht*, 68 T.C. 223 (1977) (addressing assumption of payables of a cash method taxpayer in a Section 351 transaction) and Reg. 1.752-1(a)(4).

[21] 326 F.2d 67 (8th Cir., 1964).

The Tax Court in *Hoops*, as stated above, reached a similar result. Due to changes in law, however, the disallowance of the deduction in a case like *Hoops* potentially has a harsher result than was the case in TAM 8939002. The TAM involved an asset sale and liquidation prior to the 1986 Tax Reform Act, so that the gain on sale of assets was not recognized. Including the assumption of the liability in proceeds therefore did not increase the taxpayer's gain, nor did it result in the potential whipsaw present in *Hoops.* Notably also, the TAM was issued before Reg. 1.461-4(d)(5). It did not address whether Reg. 1.461-4(d)(5) could be extended to deem a deferred compensation liability to be satisfied.

As an interesting contrast to *Hoops*, in TAM 202116062, the Service recently ruled that Reg. 1.461-4(d)(5) applied to allow a corporation to deduct a lawsuit expense that was a so-called "payment liability" under Reg. 1.461-4(g). A payment liability is one where the deduction is deemed to arise as a payment is made to the party to whom the liability is owed.[22] In the TAM, the taxpayer's manufacturing subsidiary became involved in product liability litigation. The subsidiary reached a global settlement of product liability claims that satisfied the first two prongs of the all-events test. However, since litigation settlements generally are "payment liabilities," the economic performance requirement was not satisfied until the subsidiary paid the claimants the underlying settlement amounts.

In the TAM, the taxpayer converted its troubled subsidiary into an LLC, triggering a deemed liquidation for tax purposes. The TAM states that the subsidiary was insolvent and its liquidation was governed by Rev. Rul. 2003-125.[23] Accordingly, Parent was deemed to acquire all of the assets of the subsidiary in a taxable transaction.

The TAM held that the internal sale of the subsidiary's assets was a sale of a trade or business for purposes of Reg. 1.461-4(d)(5). Since the liability was deductible but for the economic performance requirement, the TAM concluded that it was also deemed deductible in the year of the liquidation.

Interestingly here, litigation expenses, like the deferred compensation liabilities at issue in *Hoops*, are only deductible as payment is made to the person to whom the liability is owed.[24] However, since the rule deferring the deduction until payment was a component of the economic performance requirement, rather than Section 404(a)(5), Reg. 1.461-4(d)(5) deemed the deduction to be available at the same time the liability was included in proceeds.

Should a contingent liability be included in amount realized in the year of sale?

As discussed above, the Tax Court in *Hoops* also concluded that the partnership was required to include the assumption of the deferred compensation liability in proceeds, despite not being allowed a deduction for that liability in the year before the court or in any prior year. The Tax Court's discussion of this issue is relatively brief. As noted above, the taxpayer's primary position was that it should be allowed an offsetting deduction under Reg. 1.461-4(d)(5, and the argument that the liability should not be included in proceeds was the alternative position.

Left unanswered by *Hoops* was when, if ever, and in what amount, would the seller be permitted to claim an offsetting deduction for the deferred compensation liabilities assumed and later satisfied by the buyer.

In holding that the liability was included in proceeds in the year of sale, the Tax Court cited *Commercial Security Bank* (authored by Judge Tannenwald), which in turn, cited *Crane.* On closer inspection, however, neither *Commercial Security Bank* nor *Crane* directly addressed the issue decided in *Hoops.*

In *Commercial Security Bank*, the court addressed a sale of assets by a cash method corporation, where the buyer assumed obligations under accrued interest payables and also acquired rights to accounts receivable. The asset sale was governed by old Section 337, so that no gain was recognized. However, under an exception to old Section 337, the seller was taxed on accrued income built into the accounts receivable.

The primary issue in the case was whether the seller was entitled to an offsetting deduction for the assumed accounts payable. Since

[22] See Reg. 1.461-4(g)(2)(i).

[23] Under Section 165(g)(3), but for the favorable ruling in the TAM, a worthless stock loss may also have been available. However, stock losses on consolidated subsidiaries may be partly or wholly eliminated under Reg. 1.1502-36. Also, if the subsidiary failed to satisfy the active gross receipts test of Section 165(g)(3)(B), the stock loss would have been a capital loss.

[24] Reg. 1.461-4(g)(2).

the transaction was governed by old Section 337, no gain would be recognized if the assumption of the payables was treated as additional amount realized on the asset sale.

In analyzing the issue, the Tax Court in *Commercial Security Bank* described the "accrued liabilities" as ones that were included in proceeds, stating: "[i]t is also beyond question (and petitioner does not argue otherwise) that the amount of the 'accrued business liabilities' would, but for the impact of Section 337, have been taken into account in computing Orem's gain or loss from the sale."[25] While this statement would seem to be fairly definitive, the issue of whether the unmatured cash method payables were included in proceeds was not directly presented to the court, as such treatment would not have changed the corporation's gain recognized on the sale.

Moreover, the Tax Court then went on to hold that by taking reduced cash proceeds as a result of the liability, the taxpayer constructively paid the liabilities and was entitled to a deduction. The court's holding, like Reg. 1.461-4(d)(5), thus achieved an equitable matching of the inclusion of the liabilities in proceeds and the allowance of the underlying deduction.

In *Hoops*, however, the Tax Court applied the *Commercial Security Bank* decision to include the amount of the deferred compensation liabilities in proceeds, but without allowing the offsetting deduction.

[25] 77 T.C. at 148-149.

[26] *See, e.g.*, PLR 202111007 (12/21/2020).

Conclusion

The treatment of assumed contingent obligations as proceeds before they have been taken into account as basis or a deduction can achieve inequitable results. Moreover, one important issue left unanswered by *Hoops*, as well as TAM 8939002, is whether the seller would be entitled to a deduction at a later point in time. Even if the seller were to be allowed a deduction for the payment of the liability in a later period, the utilization of that deduction may be limited. In *Hoops*, for example, the partnership might have dissolved after selling its assets, and thus not been in existence in a later year when the deduction for deferred compensation was available.

Moreover, under post-Tax Cuts and Jobs Act (TCJA) law, even if the seller remains in existence, Section 172 no longer permits carryback of net operating losses. Finally, in the case of contingent liabilities that are less measurable or longer term in nature, the timing issues from the inclusion of the obligations in proceeds in advance of a deduction are themselves acute.

Administratively, the IRS and Treasury have attempted to resolve some of these issues through Reg. 1.461-4(d)(5) and also through the private letter rulings under Section 468A addressing nuclear decommissioning costs.[26] However, the *Hoops* decision is a useful reminder that such administrative relief is imperfect and, in many cases, taxpayers confronting this issue will need to consider alternatives or self-help wherever it is available. ■