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Tax Treatment of Contingent Liabilities: The Need for Reform

Ellen H. De Mont

TAX TREATMENT OF CONTINGENT LIABILITIES: THE NEED FOR REFORM

Ellen H. De Mont[*]

I. Introduction

The proper tax treatment of the assumption of deductible and nondeductible contingent liabilities[1] for both the buyer and seller in transactions involving taxable asset acquisitions[2] is currently under debate. Case law precedents and the current state of the law are contradictory or, at best, uncertain. Authority on the buyer's side in particular is undefined and authority on the seller's side is sparse. From a tax policy perspective, it is desirable to avoid rules that yield inconsistent results. A healthy economy depends in part upon businesses being able to make decisions based upon expected tax consequences, and currently, a comfortable level of predictability is not available. Consequently, transactions involving contingent liabilities become riskier and therefore more expensive for the taxpayer. The result is that such improper tax treatment could delay or discourage transactions which are desirable from a business perspective or even vital to a business' survival.

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1. In this article, any reference to the "assumption of liabilities" in an asset acquisition includes the transfer of property "subject to" a liability. Also, this article does not distinguish between recourse and nonrecourse debt when it refers to liabilities. *See infra* text accompanying notes 3-6. Deductible contingent liabilities refers to liabilities which would have been deductible to the seller had there been no sale. Nondeductible contingent liabilities, it follows, are liabilities for which the seller would not have been entitled to a deduction, such as the payment of a fine or penalty. *See infra* text accompanying notes 8-10.

2. When this article refers to taxable asset acquisitions it refers to two types of transactions. The first is where the actual assets are acquired. The second is where the transaction is a stock purchase treated as an asset acquisition within the meaning of I.R.C. § 338(h)(10) (1992). Buyers and sellers are deemed to use the accrual method of accounting unless otherwise stated.

The contingent liabilities dilemma arises frequently in a few situations. The first is where the buyer assumes all of the seller's assets in a taxable asset acquisition. In such a transaction, the buyer may also assume the seller's liabilities, including the contingent liabilities. The issue also arises in stock acquisitions treated as asset acquisitions pursuant to I.R.C. section 338(h)(10). In determining the purchase price in either type of transaction, parties have to take into consideration contingent liabilities such as pension plan contributions and other employment-related liabilities, uninsured product liability injuries that have given rise to a variety of asserted and potential claims, asserted and potential warranty claims, federal and state tax claims, and potential environmental liabilities.

In the case where the buyer assumes the seller's liabilities, the first issue to be addressed is whether the buyer may deduct payments made in satisfaction of the seller's liabilities. If it is determined that the buyer may take the deduction, then the next issue to be determined is the time the buyer should be permitted to take the deduction. In the case where the seller retains the liability or the buyer assumes the liabilities and the seller agrees to indemnify the buyer, the questions regarding who may take a deduction and when must still be determined, but are more easily answered under the current law. Any solution regarding the tax treatment of contingent liabilities must address these issues and either conform to existing law or call for legislative changes.

This article addresses the controversy surrounding the proper tax treatment of contingent liabilities in taxable asset acquisitions. It begins with a discussion of contingent liabilities and identifies the types of transactions that are affected by the treatment of contingent liabilities. Next the article presents the current state of the law regarding fixed and contingent liabilities for both buyer and seller. Subsequently, the article examines the leading reform proposals and how successful each proposal is at meeting certain policy objectives. Finally, the article presents an alternate reform proposal.

II. Contingent Liabilities and Affected Transactions

A. *Fixed Versus Contingent Liabilities*

In order to fully understand the potential problems associated with the assumption of contingent liabilities, the term "contingent liability" must first be defined. This is best achieved by differentiating fixed from contingent liabilities, and determining when such liabilities are deductible.

1. Definitions

Before understanding the distinction between fixed and contingent liabilities, it must first be understood what a liability is. Although the term liability has been broadly applied, in this article it refers to a taxpayer's economic obligation which may arise out of a contractual obligation or by operation of law.[3] Since it is the policy under the federal income tax laws to impose a tax on net income, the Internal Revenue Code ("the Code") permits taxpayers to deduct from gross income those liabilities which constitute the cost of earning income. Generally, however, the Code does not permit a taxpayer to deduct those costs associated with day to day living.[4]

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3. "Liability" has been defined as all character of debts, obligations and responsibilities. It has also been referred to as an obligation which may or may not ripen into a debt. It may be any kind of debt or liability, either absolute or contingent, express or implied. It is also viewed as a duty to pay money or perform some other service. BLACK'S LAW DICTIONARY 914 (6th ed. 1990).

4. Although the term "gross income" is broadly defined in the Code to include "all income from whatever source derived," deductions are narrowly construed and are available only where explicitly provided for in the Code. I.R.C. § 61(a) (1988). Examples include I.R.C. § 162, which provides taxpayers a deduction for ordinary and necessary expenses incurred in carrying on a trade or business, and I.R.C. § 212 which authorizes the deduction of such expenses with respect to investment activities. Sections 167 and 168 permit cost recovery through depreciation deductions. Section 165 permits a deduction for losses incurred in the taxpayer's business or in a transaction entered into for profit. Deductions for personal expenses, which represent the cost of living, are not deductible except in a few instances such as the I.R.C. § 163 deduction for home mortgage interest, the I.R.C. § 165 deduction for casualty losses, the I.R.C. § 170 deduction for charitable contributions, and the I.R.C. § 213 deduction for medical expenses. This article focuses on business deductions.

Fixed liabilities are liabilities which are certain and definite as to both the fact of the liability and the amount of the obligation.[5] In contrast, contingent liabilities are those liabilities which are not fixed at present, but upon the occurrence of some future and uncertain event would become fixed liabilities.[6] Contingent liabilities are of two basic types. First, the liability can be anticipated, but unknown as to either the certainty of the liability or the amount of the liability, or both. Second, the liability can be unanticipated.

In a taxable asset acquisition, liabilities can be either retained by the seller or assumed by the buyer.[7] If the seller retains the liability, the seller may either pay the liability directly, or the parties could enter into an indemnity agreement whereby the buyer reimburses the seller for any amount incurred in satisfying the obligation in the future.

2. Deductibility of Fixed and Contingent Liabilities

Before deducting the payment of a liability, the taxpayer must first determine whether the liability is of a type for which the Code provides a deduction. Once deductibility is assured, the taxpayer must ascertain when the deduction may be taken. In general, for a business liability to be deductible, it must be connected with or pertaining to the taxpayer's trade or business.[8] Consequently, a taxpayer may not deduct a liability that is incurred in connection with another taxpayer's trade or business. Once it is determined that the taxpayer is the taxable entity that has incurred the liability, the timing of the deduction must be ascertained. The timing of the deduction is based upon two factors: the type of liability and the taxpayer's

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5. BLACK'S LAW DICTIONARY 638 (6th ed. 1990).

6. *Id.* at 321. For examples of cases illustrating the term contingent liability, see Paul M. Crimmins, *Tax Treatment of Contingent Liabilities on the Sale of a Business*, 40 DEPAUL L. REV. 819, 821 (1991).

7. The general rule is that a buyer is not responsible for the seller's liabilities. For a list of cases on this issue and a discussion of exceptions to the general rule, see Crimmins, *supra* note 6, at 822.

8. Treas. Reg. § 1.162-1(a) (as amended in 1988). *See* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 10.1 (1988) for an in-depth analysis of the leading cases in this area.

method of accounting. In general, there are three types of liabilities. For the first type of liability, the Code explicitly prohibits taxpayers from taking a deduction. These liabilities include fines, penalties,[9] and illegal payments[10] and they are never deductible. The second type of liability includes expenses that are ordinary and necessary to the operation of a trade or business and are incurred in connection with assets that have a useful life not extending substantially beyond the close of the taxable year. For these liabilities, a current deduction is permitted under section 162 of the Code. Similarly, section 212 provides a current deduction for expenses incurred for the production of income. Next are liabilities for costs associated with items whose useful life extends substantially beyond the close of the taxable year, but whose useful life is determinable.[11] Under sections 263 and 263A, these liabilities must be capitalized and added to the taxpayer's basis. The taxpayer is permitted to recover the cost through amortization or depreciation deductions allowed under sections 167 and 168 over the useful life of the property. The third type of liability are expenses associated with assets whose useful life is not determinable. Thus, for liabilities associated with land and corporate stock, the taxpayer must wait until disposition of these assets to recover the cost.[12]

After the types of deductions have been identified, the time for taking a deduction must be determined. A deduction "shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."[13] In general, this means that a cash method of accounting taxpayer may take a deduction in the taxable year in which the liability is paid.[14] This rule applies whether the

9. I.R.C. § 162(f) (1988) denies a taxpayer a deduction under I.R.C. § 162(a) for fines or similar penalties paid to a government due to the taxpayer's transgression of any law.

10. I.R.C. § 162(c) (1988) denies a taxpayer a deduction under I.R.C. § 162(a) for bribes, kickbacks and similar payments.

11. These liabilities typically include land, buildings, machinery, equipment, and certain intangibles such as patents and copyrights whose legal life is statutorily limited. *See* Treas. Reg. § 1.167(a)-3 (1960).

12. Treas. Reg. §§ 1.167(a)-2 to -3 (1960).

13. I.R.C. § 461(a) (1988).

14. Treas. Reg. § 1.461-1(a)(1) (as amended in 1992) also provides a deduction for

liability is fixed or contingent. A taxpayer using an accrual method of accounting may not take a deduction until the time at which the "all events test" is satisfied. Under the all events test, a taxpayer gets a deduction in the taxable year in which all events have occurred that establish the liability, and the amount of the liability can be determined with reasonable accuracy.[15] Section 461(h) sets forth the additional requirement that the deduction may not be taken until "economic performance" has occurred.[16] Thus, an accrual method of accounting taxpayer may deduct a fixed liability once economic performance has occurred. A contingent liability, however, cannot be deducted until it first becomes fixed and determinable, satisfying the all events test, and then economic performance occurs.

B. *Transactions Involving Contingent Liabilities*

The types of transactions which may include the assumption of liabilities are discussed in this subsection. Nontaxable transactions are presented first. The taxable transactions in which the taxpayer needs to address the tax consequences associated with contingent liabilities are then explored, along with a discussion of the particular problems associated with contingent liabilities.

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noncash expenses such as depreciation (I.R.C. § 167), depletion (I.R.C. § 611), and losses (I.R.C. § 165). In addition, expenditures creating an asset having a useful life extending substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, in the taxable year in which they are made.

15. Treas. Reg. § 1.461-1(a)(2) (as amended in 1992). As is the case for cash method of accounting taxpayers, expenditures creating an asset with a useful life extending substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, in the taxable year in which they are made.

16. I.R.C. § 461(h)(1) (1988). For services and property provided to the taxpayer, economic performance occurs as the services or property are provided. I.R.C. § 461(h)(2)(A)(i)-(ii) (1988). If the liability arises out of the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property. I.R.C. § 461(h)(2)(A)(iii) (1988). If the taxpayer is required to provide property or services, economic performance occurs as the taxpayer provides such property or services. I.R.C. § 461(h)(2)(B) (1988). If the liability requires the taxpayer to make a payment to another and the liability arises under any workers' compensation act or out of any tort, economic performance occurs as the payments are made. I.R.C. § 461(h)(2)(C) (1988); Treas. Reg. § 1.461-4(g)(2) (1992).

1. Nontaxable Asset Acquisitions

The transfer of property to a corporation in exchange for the stock of the corporation constitutes a "sale or other disposition" such that absent the section 351 nonrecognition provision, the transferor would realize gain or loss on the full amount of the difference between the adjusted basis in the property transferred and the value of the stock received in exchange pursuant to section 1001(a).[17] Section 351 provides that the realized gain or loss shall not be recognized if the property is transferred to the corporation solely in exchange for its stock and if the transferor controls the corporation immediately after the exchange.[18]

The section 351 nonrecognition provision was enacted in furtherance of a tax policy that seeks to encourage business formation, or at least to not create impediments to such formation, and to have the requisite business transactions accomplish this based on business reasons rather than on tax considerations.[19] A section 351 transaction involving a transfer of appreciated or depreciated property to a corporation that is controlled by the transferor is viewed as a change in form only and, therefore, any gain or loss realized on the transaction should not be recognized.[20] A change in form only satisfies the

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17. I.R.C. § 1001(a) (1992).

18. The major requirements of I.R.C. § 351 are that (1) one or more persons transfer property to a corporation; (2) the transfer is solely in exchange for stock in the transferee corporation; and (3) the transferor(s) must be in control of the transferee corporation immediately after the exchange. I.R.C. § 351 (Supp. 1992). Control is defined as ownership of "at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." I.R.C. § 368(c) (1988).

19. The Senate Report on I.R.C. § 351 stated that the nonrecognition provision would "permit business to go forward with the readjustments required by existing conditions . . . ." S. REP. NO. 275, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. 181, 189.

20. "It is the purpose of [I.R.C. § 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture." Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1940).

continuity of interest requirement set forth in the regulations.[21]

In general, in a section 351 transaction the transferor recognizes neither gain nor loss on the exchange, the transferee corporation takes carryover basis in the property received, and the transferor takes substituted basis in the stock received.[22] The rules are more complicated where the transferee corporation assumes the liabilities of the transferor.

In *United States v. Hendler*,[23] the Supreme Court first considered whether the assumption and subsequent payment of a transferor's liability by the transferee corporation resulted in recognized gain to the transferor. The Court held that the transferor's assumption and payment of the transferee's liability should be regarded as a transfer of cash to the transferor in an amount equal to the assumed liability, and a satisfaction of the liability by the transferor.[24] Consequently, the transferor recognized gain. In response to the Court's decision in *Hendler*, Congress enacted section 357(a) and (b) which provides for nonrecognition of gain upon a transferee corporation's assumption of a transferor's liability so long as the principal purpose of the transaction is not tax avoidance and the transaction has a bona fide business purpose.[25]

Under section 351, the assumption of liabilities[26] does not

21. The continuity of interest doctrine embodies the tax policy objective of providing for nonrecognition of gain or loss only if the exchange pursuant to a reorganization is a change in form rather than a sale. Treas. Reg. § 1.368-1(b) (1990).

22. I.R.C. § 358(a)(1)(A) (1988) (The basis in the property received shall be the same as that of the property exchanged decreased by the amount of money received by the taxpayer).

23. 303 U.S. 564 (1938).

24. *Id.* at 566.

25. I.R.C. § 357(a) (1988) provides that the assumption of the transferor's liabilities is not treated as money or other property. Thus the transaction is not prevented from qualifying for I.R.C. § 351 nonrecognition treatment. I.R.C. § 357(c) (1988) deals with the situation where the liabilities assumed exceed the aggregate basis of the properties transferred. In such case the excess is treated as a gain on the sale or exchange of such property. For more definitive treatment of the comments in his subsection, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.06 (5th ed. 1987).

26. For a discussion on the meaning of "assumption of liabilities," which is not defined in the Code or the regulations, see BITTKER & EUSTICE, *supra* note 25, at ¶ 14.55; *Transfers to Controlled Corporations: In General*, 347-2nd Tax Mgmt. Portfolio

constitute boot to the transferor, the transferor's basis in the stock received is reduced by the amount of the assumed liability, and the transferee corporation takes a basis in the exchanged property that is unaffected by its assumption or payment of the transferor's liabilities. Upon payment of the assumed liability by the transferee corporation, rather than require that the transferee capitalize the amount of the liability and add it to its basis in the assets acquired, the Internal Revenue Service ("the Service") has ruled that such a payment is deductible by the transferee so long as there is a valid business purpose for the transfer and the transferor neither prepays the accounts payable nor accumulates the accounts receivable.[27]

Although section 351 does not address the tax treatment of contingent liabilities assumed by the transferee corporation, it appears that the rules which apply to fixed liabilities regarding the transferor would apply to deductible contingent liabilities as well.[28] The law regarding the transferee corporation is less certain. While earlier court decisions[29] denied transferee corporations a deduction for payment of deductible contingent liabilities assumed pursuant to section 351 transactions, the Service subsequently has ruled that a deduction is permitted.[30]

Thus, in a section 351 transaction, the transferee corporation is viewed as "stepping into the shoes" of the transferor. Consequently, the transferee may take a deduction for payments of assumed liabilities according to the transferee's method of accounting. If the liabilities assumed are of a deductible type,[31]

(BNA) A-60 (1988).

27. Rev. Rul. 80-198, 1980-2 C.B. 113; Rev. Rul. 80-199, 1980-2 C.B. 122; *see also* I.R.C. § 381(c)(16) (1988) (extending this rule to taxable asset acquisitions).

28. *See supra* text accompanying notes 22-25.

29. *See, e.g.*, Holdcroft Transp. v. Commissioner, 153 F.2d 323 (8th Cir. 1946) (holding that payment of a tort claim of the transferor partnership was not deductible since it represented part of the cost of acquisition of the partnership's property); M. Buten & Sons v. Commissioner, 31 T.C.M. (CCH) 178 (1972) (holding that death benefits payable to the widow of an employee of the transferor partnership were part of the cost of acquiring the partnership's property since the employee died prior to the I.R.C. § 351 transaction).

30. *See, e.g.*, Rev. Rul. 83-155, 1983-2 C.B. 38 (ruling that a transferee corporation could deduct payments made to a retired partner or spouse of the retired partner of the transferor partnership).

31. *See supra* text accompanying note 8.

this treatment applies whether the assumed liabilities are fixed or contingent.

2. Taxable Acquisitions

a. Asset Acquisitions

In a taxable asset acquisition, the acquiring corporation acquires the assets of the target corporation.[32] Difficulties may arise if the acquiring corporation also assumes the target's liabilities, both fixed and contingent. For example, if the target corporation is a cash method taxpayer, the target may have unpaid but deductible liabilities that have not yet been deducted. If the acquiring corporation is required to capitalize the liability and add it to its basis in the purchased assets, the result is that neither party can take the deduction. This problem exists whether the liabilities are fixed or contingent.

The same problem arises with respect to contingent liabilities if the seller is an accrual method taxpayer and to fixed liabilities where economic performance has not occurred. The seller cannot take a deduction for a contingent liability until it becomes fixed and determinable. If the contingent liability becomes fixed and determinable after the acquisition date, and the buyer is required to capitalize the amount of the liability, then again neither party can take the deduction.

b. Stock Acquisitions Treated as Asset Acquisitions

Section 338 of the Code permits an acquiring corporation to obtain a step-up in the basis of the target corporation.[33] If the acquiring corporation makes a section 338 election, the target's

32. Temp. Treas. Reg. § 1.1060-1T(b) (1990) defines an asset acquisition as "any transfer, whether direct or indirect, of a group of assets if (i) the assets transferred constitute a trade or business in the hands of either the seller or the purchaser, and (ii) . . . the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration." *Id.*

33. I.R.C. § 338 (1988). The step-up in basis is available to an acquiring corporation which purchases 80% or more of the stock of the target corporation. *Id.* § 338(d)(3).

assets will be deemed to have been sold to an alter ego of the target for an amount equal to the fair market value of the assets. The amount paid for the stock plus the target's liabilities is then required to be allocated to the target's assets according to the rules specified in the regulations.[34]

The asset allocation rules found in section 338(h)(10) and in section 1060 first divide the purchased assets into four classes.[35] The aggregate purchase price is then allocated among the assets in order, with any purchase price remaining allocated to goodwill.[36] If the buyer's payment of a contingent liability is deemed to be an increase in purchase price, then the buyer must allocate the additional purchase price according to the regulations rather than deduct the amount of the payment in the year of payment. The resulting tax consequences to the buyer could be harsh. Instead of a current deduction in the amount of the contingent liability at the time the contingent liability is paid, the buyer may be required to allocate the amount to goodwill. Until recently, good will was neither deductible nor amortizable, and the buyer would have to wait until it disposed of the asset to recover the cost of the payment.[37]

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34. Temp. Treas. Reg. § 1.338(b)-1T(c)(1) (1990). The basis allocation rules require first that the acquirer determine its adjusted grossed-up basis (AGUB) in the target. This includes: (1) acquirer's grossed-up basis in the recently purchased target stock; (2) acquirer's basis in nonrecently purchased target stock; (3) target's *liabilities*; and (4) "other relevant items." *Id.* For an in-depth explanation of the basis allocation rules, see *Stock Purchases Treated as Asset Acquisitions — Section 338*, 16-6th Tax Mgmt. Portfolio (BNA) A-18 (1990); Mark J. Silverman & Kevin M. Keyes, *Section 338 and Leveraged Buyout Transactions, in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS DISPOSITIONS, FINANCINGS, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS 1990, at 265 (PLI Tax Law & Estate Planning Course Handbook Series No. 303, 1990).

35. Class I assets include cash and demand deposits. Class II assets are certificates of deposit, U.S. government securities, readily marketable stock and securities, and foreign currency. Class III assets are all other tangible and intangible assets except for goodwill and going concern value. Class IV assets are allocated to goodwill and going concern value. Temp. Treas. Reg. § 1.228(b)-2T (1990).

36. See Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 TAX L. REV. 605 (1988) for a thorough analysis of the §§ 338 and 1060 asset allocation rules.

37. The Revenue Reconciliation Act of 1993 added Code § 197 which provides for the amortization of certain intangibles, including goodwill, over a 15-year period. Section 197 intangibles acquired after August 10, 1993 are eligible for the amortization deduction. The taxpayer may elect to apply this provision to all property acquired after July 25, 1991. The Treasury Department is expected to review the

III. HISTORICAL PERSPECTIVE

The proper treatment of liabilities in connection with a sale of property has been at issue for many years. One of the early cases on this subject was *Crane v. Commissioner*,[38] which specifically addressed the proper treatment of mortgage debt, and which many argue was decided incorrectly. The Supreme Court's later decision in *Commissioner v. Tufts*[39] confirmed the *Crane* decision. This section discusses *Crane* and *Tufts* and then presents the current law regarding liabilities. In addition, certain issues which the authorities have failed to address are discussed.

A. Crane *and* Tufts

The Supreme Court decided early on in *Crane* that mortgage debt[40] is included in basis at the time of purchase and the mortgage debt remaining is included in amount realized at the time of sale. This case facilitated the development of tax shelters which take advantage of accelerated depreciation and interest deductions on nonrecourse debt.[41] Recently, Congress has sought to limit the operation of such tax shelters by lengthening the depreciable life of both residential and commercial real estate,[42] and by enacting the at-risk rules[43] and the passive activity loss rules.[44] In any case, it is clear that if the amount of mortgage obligation is added to basis, it is to be included in amount realized.

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operation of the regulations under §§ 338 and 1060 in light of the new § 197. Committee Report on P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993).

38. 331 U.S. 1 (1947).

39. 461 U.S. 300 (1983).

40. Mortgage debt is a type of liability which is added to basis and then recovered through depreciation deductions.

41. The impact of this case cannot be understated. One source has noted that the cases prior to *Crane* answered the question of whether a liability is to be added to purchase price more consistently than do the cases that follow and stated that cases are now "answered on a case by case basis, apparently without the benefit of any coherent theory." William B. Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67, 68 (1973).

42. I.R.C. § 168(c) (1988).

43. *Id.* § 465.

44. *Id.* § 469.

The Supreme Court left unanswered in *Crane* the question of whether this same rule applies if the value of the property is less than the amount of the mortgage.[45] The Supreme Court returned to answer this question in *Tufts*, holding that the fact that the amount of the mortgage exceeds the fair market value of the property at the time of the disposition is irrelevant.[46] Thus, upon disposition of property encumbered by a mortgage that is reflected in the seller's basis, the amount of the remaining mortgage must be included in the seller's amount realized.[47]

B. *Current State of the Law*

The tax treatment of fixed and determinable liabilities for both buyer and seller is relatively well settled and is presented first as a foundation for understanding the tax treatment of liabilities. The subsequent subsection explores the existing law on the tax treatment of contingent liabilities. This law is more complex than the law relating to fixed liabilities and is often sparse or inconsistent.

1. Fixed Liabilities

The general rule is that in a taxable sale of assets the seller's amount realized includes the amount of the seller's fixed liabilities assumed by the buyer.[48] The seller is permitted an offsetting deduction under section 162 of the Code in the amount of the assumed fixed liability, if the liability is deductible.[49] This is illustrated in *Commercial Security Bank v. Commissioner*,[50] where the taxpayer sold all its assets pursuant to a liquidation plan in exchange for cash and the assumption of

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45. Crane v. Commissioner, 331 U.S. 1, 14 n.37 (1947).
46. Commissioner v. Tufts, 461 U.S. 300, 307 (1983).
47. For an in-depth discussion of *Crane* and *Tufts*, and an analysis of what the buyer's basis should be in cases where the property acquired is subject to a mortgage that exceeds the property's fair market value, see Erik M. Jensen, *The Unanswered Question in Tufts: What Was The Purchaser's Basis?*, 10 VA. TAX REV. 455 (1991).
48. Treas. Reg. § 1.1001-2 (1993); *See supra* text accompanying note 40.
49. *See supra* text accompanying note 8.
50. 77 T.C. 145 (1981).

its deductible fixed liabilities. The court agreed with the taxpayer that by accepting less cash for its assets in exchange for the assumption of the taxpayer's liabilities, the taxpayer effectively paid the liabilities at the time of the sale.[51]

This same treatment is found in section 338(h)(10) transactions. In a stock acquisition in which a section 338(h)(10) election has been made, the regulations provide that the sales price includes the amount of the fixed liabilities of the corporation.[52] Similarly, the Service has ruled that the seller is permitted an offsetting deduction in the amount of the assumed fixed deductible liabilities.[53]

Section 404 represents an exception to the general rule. This section does not permit an employer to take a deduction for contributions to a pension plan until the time that the employer actually makes the payment.[54] Therefore, the buyer's assumption of the seller's section 404 fixed deductible liabilities is not deemed to constitute economic performance as required for deductibility under section 461(h) and as found in the general rule. Consequently, the Service has ruled that the seller does not receive an offsetting deduction at the time of acquisition.[55]

The tax consequences to the buyer are more complicated. The general rule is that in an asset acquisition that includes the acquisition of fixed liabilities, the buyer includes the amount of such liabilities in cost basis.[56] The regulations require the buyer to allocate the amount of the fixed liability among the acquired assets using the residual allocation method.[57] Since the payment of the fixed liability is viewed as part of the purchase price, and the liability "belongs" to the seller, no deduction is permitted to the buyer at the time the buyer pays the

51. *Id.* at 149.
52. Temp. Treas. Reg. § 1.338(h)(10)-1(f) (1994).
53. Tech. Adv. Mem. 87-41-001 (June 16, 1987).
54. Contributions made within three and one-half months after the close of the calendar year are treated as having been made in the prior calendar year. Treas. Reg. § 1.404(h)-1(a)(3) (1990).
55. Tech. Adv. Mem. 89-39-002 (June 15, 1989).
56. I.R.C. § 1012 (1993) states that "[t]he basis of property shall be the cost of such property." *See also* Lifson v. Commissioner, 98 F.2d 508 (8th Cir. 1938), *cert. denied*, 305 U.S. 662 (1939).
57. Temp. Treas. Reg. § 1.1060-1T(d) (1988).

liability. The Code and regulations fail to make a distinction between deductible and nondeductible fixed liabilities.

Section 338(b)-2T and the regulations thereunder require the buyer to allocate the adjusted grossed-up basis among the assets of the acquired corporation in accordance with the regulations.[58] The adjusted grossed-up basis is defined as the sum of the buyer's basis in the stock, the target's liabilities, and other relevant items.[59] The buyer must allocate subsequent adjustments in the adjusted grossed-up basis to the target's assets.[60] Again, no distinction is made between deductible and nondeductible fixed liabilities.

Section 404(a) presents an exception to the general rule. As discussed previously, this section does not permit an employer to take a deduction for contributions to a pension plan until the employer actually makes the payment.[61] On the one hand, buyers may deduct payments for unfunded past service liabilities with respect to qualified pension plans assumed by the buyer. On the other hand, buyers must capitalize amounts paid to fund accumulated funding deficiencies with respect to nonqualified pension plans.[62]

2. Contingent Liabilities

The general rule for the tax treatment of contingent deductible liabilities requires that the seller include the amount of the contingent liability in income at the time of acquisition.[63] In addition, the seller receives an offsetting deduction at the time of acquisition pursuant to section 162,[64] the same as the rule for deductible fixed liabilities.[65]

58. Temp. Treas. Reg. § 1.338(b)-2(T) (1986).
59. *Id.* § 1.338(b)-1T(c)(1).
60. *Id.* § 1.338(b)-3T.
61. *See supra* notes 54-55 and accompanying text.
62. See Priv. Ltr. Rul. 86-23-033 (Mar. 11, 1986); Priv. Ltr. Rul. 84-11-106 (Dec. 16, 1983); Tech. Adv. Mem. 84-36-002 (Mar. 23, 1984).
63. James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964); Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981).
64. *See id.*
65. *See supra* notes 8, 49.

Section 1060 fails to directly address the treatment of transactions which include the assumption of contingent liabilities. Section 338(h)(10) requires that the amount realized by the seller on the date of acquisition include only fixed liabilities. The regulations under this section require the seller to make an accounting when an event occurs that fixes a liability. This accounting serves to increase the buyer's basis which should correspondingly increase the seller's amount realized.[66] Contrary to the law with respect to fixed liabilities, however, the Service concluded in a Technical Advice Memorandum that the seller should not receive an offsetting deduction.[67] This advice, however, has been rescinded and replaced with a better-reasoned result which grants the seller a deduction in such cases.[68]

The case law dealing with the tax treatment of a seller who is relieved of contingent liabilities is sparse. In *James M. Pierce Corp. v. Commissioner*,[69] the taxpayer set up a reserve for unearned subscription income and did not report the reserve in income. In a taxable asset acquisition, the taxpayer's liabilities, including the unearned subscription reserve, were assumed by the buyer. The court held that the seller had to report the assumption of the reserve in income since subsequent to the sale the seller no longer had a reserve.[70]

In *Fisher Co. v. Commissioner*,[71] the Tax Court confirmed the determination that the seller must include the assumption of its obligation to repair a roof as part of the amount realized. The court, however, never had to reach the issue of whether the seller could take an offsetting deduction or had to add the amount to its basis in the roof.

66. Temp. Treas. Reg. § 1.338(h)(10)-1T(f)(2), 1.338(b)-3T(h)(1)(i) (1990).

67. Tech. Adv. Mem. 87-41-001 (June 16, 1987).

68. Tech. Adv. Mem. 91-25-001 (Dec. 24, 1990).

69. 326 F.2d 67 (8th Cir. 1964).

70. *Id.* It has been noted that *Pierce* may have limited application since the case involves the special rules of I.R.C. § 455 which deal with prepaid subscription income. Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 TAX LAW. 765, 774 (1991).

71. 84 T.C. 1319 (1985).

The proper tax treatment of the buyer is not clear. The tax treatment of contingent liabilities is not addressed in section 1060 or the section 1060 regulations. The buyer is required to allocate the acquisition cost among the acquired assets using the residual allocation rule set forth in the regulations. Assuming that the payment of a contingent liability constitutes a change in acquisition cost, the buyer must take into account subsequent changes in purchase price "under applicable principles of tax law," allocating such changes in purchase price among the assets acquired.[72] No distinction is made between contingent liabilities that would have been deductible to the seller had they become fixed and determinable and those which never would have been deductible.

In a section 338(h)(10) transaction, the buyer is required to capitalize the cost of contingent liabilities and allocate the cost among the buyer's assets in accordance with the regulations.[73] This capitalization, however, is delayed until the time at which the contingent liability becomes fixed and determinable.[74] Again, no distinction is made between contingent liabilities which would have been deductible to the seller once they became fixed and those which would not.

The case law dealing with the tax treatment of buyers in connection with the assumption of contingent liabilities is diverse. In *Pacific Transport Co. v. Commissioner*,[75] the buyer assumed as part of a stock acquisition the seller's contested tort liability which arose in connection with a cargo ship lost at sea. The final judgment was significantly more than what was expected. The Tax Court allowed the buyer's deduction of its payment on the ground that the liability was speculative and remote to the extent that the parties could not have intended it to factor into the purchase price.[76] The Ninth Circuit reversed, holding that the buyer had to add the amount of the payment of the liability to basis on the ground that it was a capital cost

72. Temp. Treas. Reg. § 1.1060-1T(f) (1990).
73. Temp. Treas. Reg. § 1.338(h)(10)-1T(f), 1.338-2T, 1.338-3T (1990).
74. Temp. Treas. Reg. § 1.338-3T(a)(1) (1990).
75. 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974).
76. 29 T.C.M. (CCH) 133 (1970), *rev'd per curiam*, 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974).

incurred in connection with the acquisition of the seller's assets.[77]

Similarly, in *Holdcroft Transportation v. Commissioner*,[78] the court had to determine the deductibility of court claims that were contested at the time a partnership was incorporated. The court held that the payment of the claim had to be capitalized since it represented a part of the acquisition cost and did not arise out of the operations of the successor corporation.[79]

In *David R. Webb Co. v. Commissioner*,[80] the buyer in an asset acquisition assumed the seller's liability to make lifetime payments to a beneficiary under a nonqualified pension plan. The court held that the buyer had to capitalize the payments at the time the payments to the beneficiary were made.[81] If the payments had been made to a qualified plan, however, the Service has ruled that such payments would be deductible by the buyer at the time of payment.[82]

In *F&D Rentals v. Commissioner*,[83] the court denied the buyer a deduction for an accrued but unpaid pension liability and prohibited the buyer from adding the unpaid liability to basis on the date of acquisition on the ground that the liability was contingent and could not be valued.[84] The court never addressed the issue of whether the buyer could add the amount of the assumed pension liability to its basis at the time of payment.

Hyde v. Commissioner[85] focused on the deductibility of interest. The Tax Court held that the buyer could deduct interest payments on assumed obligations only to the extent that the interest had accrued subsequent to the date of acquisition.[86]

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77. 483 F.2d at 214.
78. 153 F.2d 323 (8th Cir. 1946).
79. *Id.* at 324.
80. 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983).
81. *Id.* at 1137.
82. *See, e.g.*, Priv. Ltr. Rul. 86-23-033 (Mar. 11, 1986).
83. 44 T.C. 335 (1965), *aff'd*, 365 F.2d 34 (7th Cir. 1966), *cert. denied*, 385 U.S. 1004 (1967).
84. *Id.* at 345, 348.
85. 64 T.C. 300 (1975).
86. *Id.* at 305.

In *Albany Car Wheel Co. v. Commissioner*,[87] the buyer claimed that it assumed the seller's liability for severance pay and added the amount to its basis in the acquired assets. The buyer re-negotiated the severance pay contract which made the buyer liable for severance pay only if it failed to give adequate notice to an employee. The court held that the notice requirement made the liability too speculative, such that the buyer should not include the amount in basis, but should deduct the payment when, and if, made.[88]

James M. Pierce Corp. v. Commissioner[89] has been cited as support for the implication that the assumption of contingent liabilities by the buyer results in the buyer's inclusion of the amount of the liability in income, addition of the amount to basis, and deduction of the expense at the time of payment.[90]

Thus, the case law illustrates a variety of potential tax treatments for the buyer in connection with the assumption of contingent liabilities in a taxable asset acquisition. First, the buyer could deduct the liability when the liability becomes fixed and determinable and economic performance occurs. Second, the buyer could include the amount of the liability in the cost basis of the acquired assets at the time the contingent liability is satisfied. Finally, the buyer could include the amount of the liability in basis at the time of acquisition and deduct the amount of the liability at the time of payment.[91]

IV. SURVEY OF REFORM PROPOSALS

A. *Policy Objectives*

Currently, there is a call for reform with respect to the tax treatment of contingent liabilities in taxable asset acquisitions. Some authorities, such as Alfred D. Youngwood, feel strongly

87. 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964).
88. *Id.* at 841.
89. 326 F.2d 67 (8th Cir. 1964).
90. N.Y. ST. B.A. Tax Sec., *Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions*, (Oct. 16, 1990) at 1322 [hereinafter *Report*].
91. *See id.*

that any effective reform must be in the form of legislative change,[92] and some legislative changes are already in place.[93] Although the law in this area needs clarification, legislation may not be necessary.

Any reform should further certain important tax policy objectives. Perhaps the most important objective is that the proposed reform be easy to administer.[94] This means that taxpayers should have rules which yield predictable results and do not cause difficult compliance or monitoring problems for either the taxpayer or the Service. In addition, the proposal should neither discourage nor encourage taxable asset acquisitions.[95] Also, any reform should be revenue neutral and should not create deductions that would not have existed absent the reform or accelerate the time for taking a deduction.[96] It is also desirable that the tax treatment to the seller be fixed and determinable on the date of the transaction.[97] Finally, any proposal should not create any significant discontinuity between accounting and tax allocations of purchase price.[98]

B. *Survey of Existing Reform Proposals*

This section reviews three of the reform strategies which have been proposed. The various proposals include: (1) requiring the seller to include the amount of the assumed contingent

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92. Youngwood argues that the plethora of cases and regulatory provisions on the buyer's side of the transaction make reform other than through legislation a patchwork solution at best. He feels that the virtual absence of authority on the seller's side also calls for legislative action since years of silence on the issue may be deemed precedent for imposing no tax consequences on the seller. Youngwood, *supra* note 70, at 782.

93. *See, e.g.*, I.R.C. § 404(a) (Supp. 1992) (permitting buyers to deduct the assumed seller's pension fund liabilities at the time of payment); I.R.C. § 164(d) (1988) (permitting the buyer to deduct payments of real property taxes based on the buyer's period of ownership). Section 164(a) overruled the holding in *Magruder v. Supplee*, 316 U.S. 394 (1942), in which the Supreme Court denied the buyer's deduction for payments of real property taxes for which the buyer was not personally liable.

94. Youngwood, *supra* note 70, at 783.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

liabilities in amount realized on the acquisition date and take an offsetting deduction or increase in basis, and the buyer to include the amount of the assumed contingent liabilities in basis; (2) affording the seller nonrecognition treatment at the time the contingent liabilities are assumed, and allowing the buyer a deduction in the amount of the assumed contingent liability at the time that the all events test is satisfied and economic performance has occurred; and (3) permitting the buyer to deduct the contingent liability at the time that the seller would have taken the deduction had there been no sale.[99] The following subsections discuss these proposals.

1. Seller Includes Contingent Liabilities in Amount Realized and Takes Deduction or Basis Adjustment, Buyer Gets Deduction or Basis Adjustment[100]

Under Youngwood's proposal, valuing the contingent liabilities on the date of acquisition would permit the seller to include in its amount realized the amount of the contingent liabilities and receive a corresponding deduction or increase in basis, depending on the type of deductible contingent liability assumed.[101] No offsetting deduction or basis increase would be permitted for nondeductible liabilities such as penalties and taxes. The buyer would be required to take basis in the acquired assets equal to the purchase price, which would include the value of the assumed contingent liabilities. At the time that the buyer satisfies a contingent liability, the amount of the liability will not be deductible to the extent that the liability was already added to basis at the time of acquisition. Subsequent increases or decreases in the value of the contingent liability, determined on the date the liability becomes fixed and economic performance occurs, would be allocated among the buyer's assets in accordance with the section 338 regulations.[102]

99. *Id.* at 783-84.
100. *Id.*
101. *Id.* at 783.
102. *Id.* at 784.

This proposal has two identified advantages.[103] First, bargain purchase problems inherent in the current law are eliminated. Second, although the buyer may have to make subsequent adjustments,' the seller receives closed transaction treatment.[104] Thus, the proposal is easy for the taxpayer to administer, and the tax treatment to the seller is determined on the date of acquisition.

However, Youngwood concludes that the advantages associated with his proposal are outweighed by the revenue problems that it creates.[105] This proposal encourages the buyer and seller to inflate the value of the contingent liabilities so that the buyer can take advantage of accelerated basis recovery. Moreover, the seller has potential ordinary deduction or capital gains treatment depending on whether the seller takes an offsetting deduction for the contingent liabilities or adds the amount to basis.[106] This situation would be difficult for the Service to monitor and results in a potentially significant decrease in revenue. In addition, should the value of the contingent liabilities ultimately be higher or lower than originally valued, the respective income recognition or basis reduction would encourage buyers to prolong the contingent status of the liability.[107]

2. Nonrecognition Treatment for Seller and Deduction for Buyer[108]

Youngwood also suggests a second approach which would grant the seller nonrecognition treatment at the date of acquisition and would allow the buyer a deduction for contingent liabilities at the time that the seller would have received a deduction absent the sale to the buyer, i.e., when the all events test is met and economic performance has occurred.[109] The seller would not be required to include the amount of the assumed

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103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.* at 784-85.
109. *Id.* at 784.

contingent liabilities in income, except for the amount of nondeductible liabilities such as penalties and taxes for which the seller never would have been able to take a deduction.[110] Special rules would have to be provided in the section 455 prepaid subscription area. The buyer, however, would treat section 404 liabilities as fixed contingent liabilities, which would not produce income or a deduction for the seller.[111]

Although certain anti-abuse provisions would be required,[112] Youngwood contends that this alternative satisfies all of the above stated policy objectives, except for the requirement that there be continuity between business accounting allocation of purchase price and tax accounting allocation of purchase price.[113] In fact, it is proffered that by removing the uncertainty of the tax treatment in transactions involving the assumption of contingent liabilities, this solution would actually generate more revenue than under the current law.[114]

3. Nonrecognition Treatment for Seller and Deduction of Contingent Liability by the Buyer[115]

This proposal suggests that the proper tax treatment of contingent liabilities in a taxable asset acquisition is for the seller to recognize no income upon the buyer's assumption of a contingent liability, assuming that the liability would have been deductible to the seller.[116] In the event that the assumed liability is a nondeductible liability, such as a penalty or tax, the

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110. *Id.*

111. *Id.*

112. It is proposed that rules similar to I.R.C. § 384 and Treas. Reg. § 1.1502-15 (1990) dealing with excessive built-in deductions, and rules which would limit purchase price payments from being disguised as contingent liabilities represent the types of anti-abuse provisions that would be needed. Youngwood, *supra* note 70, at 784-85.

113. This objective can be met as well through a revision of the I.R.C. § 338 and I.R.C. § 1060 regulations dealing with purchase price allocation. *Id.* at 785.

114. *Id.*

115. *Report*, *supra* note 90, at 1320, 1324-25. This proposal has been endorsed, in part, by Charlotte Crane in her article, *Accounting For Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless?*, 48 TAX NOTES 225, 225 (1990).

116. *See* Crane, *supra* note 115, at 225.

seller would recognize income and would not receive an offsetting deduction. The buyer would be permitted to deduct the amount of the liability when the all events test is met and economic performance has occurred. The buyer would be required to capitalize contingent liabilities, such as assumption of section 404(a) pension liabilities and contested liabilities, to comport with case precedents.[117] Also, if the buyer pays the assumed contingent liability subsequent to the date of acquisition, the buyer should be permitted to deduct the interest which accrued between the date of acquisition and the date of payment.

Several advantages have been offered in support of this proposal.[118] First, this approach generally does not afford the seller the opportunity to offset capital gain with an ordinary deduction for deductible contingent liabilities. Second, there is no income deferral since income attributable to the assumption of a deductible contingent liability is offset by a deduction, resulting in no tax liability.

The offered support for affording the buyer a deduction is stronger. First, since the assumed contingent liabilities represent ongoing costs of doing business, they should not be allocated to goodwill under the section 1060 and section 338 allocation rules. Further, such allocation of assumed contingent liabilities would be administratively complex. Next, if the buyer is not permitted to deduct the payments made in satisfaction of contingent liabilities, there is a mismatching of income and expense items. In addition, a denial of a deduction for the cost of contingent liabilities such as retiree medical benefits and environmental cleanup would increase the cost of funding such liabilities. Further, it would be administratively difficult to differentiate the cost of such assumed contingent liabilities

117. For case law which requires this different treatment, see *David R. Webb Co. v. Commissioner*, 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983) (requiring buyer to add to basis payments made in satisfaction of an assumed obligation to pay pension payments); *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973) *cert. denied*, 415 U.S. 948 (1974) (per curiam) (requiring buyer to capitalize payments made in satisfaction of assumed contested tort liability); *Report*, *supra* note 90, at 1325. For a discussion on the I.R.C. § 404 policy issues, see *id.* at 1328.

118. See *Report*, *supra* note 90, at 1325-27 for an in-depth discussion on these issues.

which arose prior to the acquisition, and the accrued cost after the acquisition which would be deductible to the buyer. Finally, it is argued that requiring the buyer to capitalize what the seller would have been able to deduct absent the sale results in an asymmetrical treatment of buyer and seller which would impede taxable acquisitions.

Critics of this approach, however, have noted that there are certain shortcomings associated with the approach's claimed advantages.[119] First, the proposal enables the buyer to "step-into-the shoes" of the seller, similar to the treatment of tax-free reorganizations under section 381(a). Unlike section 381(a), however, this approach would require the buyer to take a zero basis in the portion of the assets acquired allocable to the assumed contingent liabilities. The proponent argues that the section 381(a) model does not apply to the proposed approach since section 381(a) is limited to the treatment of assets acquisition where the buyer is a continuation of the seller.[120]

Second, the approach results in no increase in tax burden for the buyer and seller. The proponent argues that this criticism is based solely on observation rather than in law.[121]

Finally, allowing the buyer a deduction for unaccrued liabilities provides an administratively easy solution.[122] This is true to the extent that the proposal does not require the deductible contingent liability to be valued at the time of acquisition. Also, it does not require interest imputation. In addition, it does not require the buyer to make subsequent basis adjustments.[123] There is, however, a cost to the government for allowing the buyer a deduction. Consequently, the buyer and seller are not in the same net economic position which they would have been had there been no sale. When the time value of money is factored into the equation, the tax consequences of the proposal

119. *Report*, *supra* note 90, at 1327.
120. *Id.*
121. *Id.*
122. It is administratively easy because a value need not be assigned to the liability at the time of acquisition. In addition, a discount rate need not be imputed to the buyer. Also, elaborate basis adjustments long after acquired assets have been retired is avoided. *See* Crane, *supra* note 115, at 226.
123. *Id.* at 226.

will have the same effect as the tax consequences associated with nonrecognition treatment for the acquisition.[124]

V. ANALYSIS OF REFORM PROPOSALS

A. *Introduction*

Although the reform proposals discussed in Section IV would achieve many of the stated policy objectives, there are some problems associated with the proposals. This section analyzes the three proposals, identifies the difficulties, and proposes an alternative reform strategy.

B. *Difficulties with Current Reform Proposals*

1. Buyer Deduction

Both the second and third alternatives outlined above[125] would afford the buyer a deduction for assumed deductible contingent liabilities at the time of payment. The timing of the buyer's deduction, however, is not the key issue. The first hurdle that must be overcome is a determination of whether the buyer has a right to take the deduction.

Allowing the buyer such a deduction, even if the deduction is limited to the deduction of items which would have been deductible by the seller had there been no sale,[126] is an incorrect solution to the contingent liability problem since it would per-

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124. *Id.* Crane provides a mathematical analysis of the different tax consequences resulting from the cases where: (1) there is no sale; (2) there is a sale but the liability is retained by the seller; and (3) there is a sale with the buyer deducting the liability at the time the buyer pays the liability. The buyer's deduction proposal effectively allows nonrecognition treatment to the extent of the present value of the assumed contingent liability. *Id.* at 226-27. "Providing the same treatment when there is a sale as is available when there is no sale achieves a neutrality that will only rarely be justified." *Id.* at 227.

125. *See supra* text accompanying notes 108-124.

126. Otherwise, the buyer would be granted a deduction for items that would not have been deductible in the hands of the seller in the absence of the sale. This is an even worse outcome since the taxpayer would receive a deduction for an item that is not granted a deduction under the Code.

mit the buyer to deduct that which the buyer has no legal right to deduct. The general rule is that a taxpayer cannot take a deduction for payment of a liability which belongs to another taxpayer. A taxpayer "owns" and can take a deduction only for payments of those liabilities which arose out of the taxpayer's own business operations.[127]

The above-stated rule regarding the deductibility of liabilities certainly applies to taxable asset acquisitions. It could be argued, however, that the buyer should be allowed to deduct payments made in satisfaction of assumed contingent liabilities in section 338(h)(10) transactions. The rationale here is that there is a continuity of interest since the taxable entity that incurred the liability is the same taxable entity that ultimately pays the liability.[128] Since this is a change in form rather than substance, the buyer is legally entitled to take the deduction.

The continuity of interest rationale is analogous to the tax treatment in a section 351 nontaxable asset acquisition transaction. For the buyer to qualify for section 351 treatment, the buyer must be in control of the corporation after the exchange.[129] If this requirement is met, the buyer takes carryover basis in the assets acquired and a deduction for the assumed liabilities at the time of payment as determined under the buyer's method of accounting.[130] Thus, if this same control requirement is met in a section 338(h)(10) transaction, it follows that the buyer should receive the same treatment. In this case, perhaps the buyer should take carryover basis and should be permitted to deduct payments of deductible contingent liabilities at the time of payment.

2. Valuing Contingent Liabilities on the Date of Acquisition

The problem associated with valuing contingent liabilities on the acquisition date was correctly identified by the proponent of

127. *See supra* note 8 and accompanying text.
128. *See supra* note 21 and accompanying text.
129. *See supra* note 18.
130. *See supra* text accompanying notes 17-31.

the first approach[131] as a temptation for the buyer and seller to conspire to inflate the value of the contingent liabilities so that the buyer can take advantage of accelerated basis recovery and the seller can get potential ordinary deduction or capital gains treatment.[132] An anti-abuse provision, however, would effectively address this difficulty. Such a provision should permit the Service to reallocate the amount of the purchase price attributable to the assumed contingent liabilities in a manner which reflects economic reality.[133]

C. *Alternate Reform Proposal*[134]

1. Tax Treatment to the Seller

This proposal would apply the general rule with respect to the seller.[135] The seller would be required to include the amount of the assumed contingent liability in income at the time of acquisition. If the assumed contingent liability is deductible in nature, then the seller would get an offsetting deduction in the amount of the assumed contingent liability at the time of acquisition. No deduction would be permitted for nondeductible contingent liabilities. This treatment comports with the well-reasoned opinion in *Pierce v. Commissioner*.[136] In addition, an exception would apply regarding section 404 liabilities such that the seller receives neither income nor a deduction upon the buyer's assumption of such liabilities.[137]

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131. *See supra* text accompanying note 105.
132. *See supra* text accompanying note 108.
133. *See* BITTKER & EUSTICE, *supra* note 25. I.R.C. § 482 focuses on the economic reality of a transaction and empowers the Service to allocate items of income and deduction among related taxpayers "to prevent evasion of taxes or clearly to reflect income . . . ." in transactions such as the sharing of facilities, properties, and services among members of a controlled group where the costs are not properly allocated; in the transfer of assets or activities to a related party; and, transactions involving loans, leases, licenses, sales or services between related entities where the price is not based on an arm's-length standard. *Id.* ¶ 15.03.
134. This solution was developed in consultation with members of the Internal Revenue Service, National Office.
135. *See supra* note 63 and accompanying text.
136. 326 F.2d 67 (8th Cir. 1964).
137. *See supra* note 117 and accompanying text.

2. Tax Treatment to the Buyer

This proposal suggests that at the date of acquisition, the buyer is not required to do anything with respect to assumed contingent liabilities. The rationale behind this treatment is that at the date of acquisition, the liability is too indefinite for the buyer to be considered as having acquired a liability.[138] At the time that the contingent liabilities become fixed and determinable, and economic performance occurs,[139] the buyer would include the amount of the assumed deductible or nondeductible contingent liability in basis, including section 404 liabilities. In the case where the liability has increased in value since the date of acquisition, the buyer would receive an interest deduction. If the liability has decreased in value, the amount added to basis would be decreased by that amount.

The buyer would then allocate the basis among the acquired assets using the residual allocation method specified in the regulations.[140] If basis is allocated to an asset which has been depreciated, then the basis allocated to that asset would be added to the asset's adjusted basis.[141] For assets that have been sold, the buyer would report a capital loss in the amount of the basis allocated to that asset.[142]

3. Analysis and Additional Concerns

This proposal achieves many of the policy objectives stated above.[143] It is easy for the seller, buyer, and Service to administer. Also, the seller receives closed transaction treatment on the date of acquisition. Admittedly, the proposal does accelerate the time at which the seller may take a deduction for a deductible contingent liability. The ease of administration associated

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138. See Crimmins, *supra* note 6, at 832.
139. In the case of a buyer on the cash method of accounting, it could also be when payment is made. *See supra* notes 13-14.
140. Temp. Treas. Reg. §§ 1.1060-1T(d) (1988), 1.338(b)-2T (1992).
141. Temp. Treas. Reg. § 1.338(b)-3T (1992).
142. Arrowsmith v. Commissioner, 344 U.S. 6 (1952).
143. *See supra* text accompanying notes 92-93.

with this approach, however, outweighs the amount of lost revenue associated with the seller's accelerated deduction.

The buyer, however, may be forced to wait to recover its cost associated with the assumed contingent liabilities for that portion of the contingent liabilities allocated to goodwill until the time the buyer disposes of the assets. This concern will be less of an issue, however, for assets acquired after August 10, 1993.[144]

It could also be argued that the buyer in a section 338(h)(10) transaction should be permitted to take a deduction upon the payment of an assumed deductible contingent liability. Since a section 338(h)(10) transaction represents a change in form and not a change in ownership, the taxpayer who incurred the liability would be the taxpayer taking the deduction, as in the section 351 situation.[145]

An additional concern in the development of a viable tax treatment for contingent liabilities has been the effect on the funding of environmental liabilities in taxable asset acquisition. Under the proposed solution, the tax treatment of environmental liabilities would be determined according to state law. If the seller is deemed the "owner" of the liabilities at the date of acquisition, then the rules proposed above would apply. In the case where the buyer is deemed the "owner" of the liabilities, then the buyer would be permitted to deduct payments made in satisfaction of contingent deductible environmental liabilities.

It is also recommended that two anti-abuse provisions be provided. First, there should be an anti-abuse provision to prevent taxpayers from inflating the value of the contingent liabilities so that the buyer could take advantage of accelerated depreciation and the seller could receive an increased deduction or reduced capital gain.[146] Second, since the tax treatment is different for fixed liabilities than it is for contingent liabilities, especially with respect to the buyer, there should be an anti-

144. *See supra* note 37.
145. *See supra* text accompanying notes 20-21.
146. *See supra* text accompanying note 105-07.

abuse provision which would discourage taxpayers from characterizing liabilities incorrectly.

VI. CONCLUSION

Clearly there is a need for reform in the tax treatment of contingent liabilities in taxable asset acquisitions and related transactions. The current state of the law, especially with respect to the buyer, is uncertain and can lead to inconsistent results.

In an effort to provide some predictability in this area, various proposals for reform have been offered. Any viable reform strategy, however, will have to be easy to administer, neither encourage nor discourage taxable asset acquisitions, be revenue neutral, not create deductions or accelerate the time for taking a deduction, and not create any significant discontinuity between accounting and tax allocations of purchase price.

It is contended that such a strategy can be crafted within the purview of current law and without legislation, except in the case where the reform would grant the buyer a deduction for the payment of assumed deductible contingent liabilities. One strategy would be to require the seller, at the date of acquisition, to include in income the value of the assumed contingent liabilities and grant the seller an offsetting deduction for assumed deductible contingent liabilities. The buyer would be required to do nothing on the date of acquisition, but would receive fixed liability treatment at the time that the buyer paid or accrued the contingent liabilities. An exception would have to be provided for section 404 liabilities, and certain anti-abuse provisions would be necessary. This strategy, however, would provide taxpayers with much needed guidance and would achieve most of the stated policy objectives.