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More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business

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I. INTRODUCTION

In his article "Assumption of Contingent Liabilities on Sale of A Business," which appeared in this journal last year,¹ Professor Daniel Halperin ably describes the stakes involved in properly accounting for contingent liabilities assumed by a buyer in asset acquisitions. His primary conclusion is that a buyer of a business who assumes contingent liabilities should not be allowed, as some have urged, a deduction upon payment on these liabilities. Although I agree with much of Professor Halperin's analysis and almost all of his conclusions, I disagree with some of his underlying assumptions about the universal nature of contingent liabilities.

Professor Halperin's analysis relies heavily on the related underlying assumptions that (1) there is always a legitimate reason for deferring a deduction until the person to whom the contingent liability is owed has been identified and that person has taken the amount into income and (2) more often than not, the expected value of the payments to be made on the liability can reasonably be valued in advance. If either of these assumptions is unfounded, the problems posed by contingent liabilities are more difficult than Professor Halperin's analysis might suggest, although his ultimate resolution of the situation may nevertheless be the best one available.

This comment will explore Professor Halperin's underlying assumptions regarding contingent liabilities and examine the stakes involved in fashioning tax accounting rules that rely upon them. It will attempt to demonstrate that at least some liabilities, including some contingent liabilities,² are different from the liabilities upon which Professor Halperin's analysis is based. This difference may not easily be accommodated in an income tax based on realization. Nevertheless, this difference may undermine both the assumption that there is a legitimate reason for deferring a payor's deduction until the ultimate payee is known and has been taxed, and may make it substantially more difficult to establish an appropriate value for the liability in advance of payment.

1. Daniel I. Halperin, *Assumption of Contingent Liabilities on Sale of a Business*, 2 Fla. Tax Rev. 673 (1996) [hereinafter Halperin, *Assumption*].

2. As did Professor Halperin, these comments will ignore those contingent liabilities that represent payments for which no payor would ever be entitled to an offset against income, whether as a current deduction or an addition to basis. Such liabilities include federal income taxes and amounts limited by the provisions of §§ 162(c) and 162(f). The former most likely should be accounted for at the time of sale by requiring the seller to take an amount into income without offset. The latter are policy deviations from the results which would be produced by strict adherence to technical notions of income, and, as such, their implementation in transactions involving the assumption of such liabilities is more appropriately viewed as a matter of policy as well.

My disagreement with Professor Halperin about the variations among contingent liabilities has little practical consequence if (as may well be the case) workable tax accounting rules cannot be fashioned to accommodate the differences among such liabilities and other deferred payments. It may also be true that failing to deal with these cases separately will not produce intolerable results. Nevertheless, I fear that some readers may ignore his conclusions because, from their point of view, he seems to be concerned only with the easy cases for which his assumptions seem reasonable. Since Professor Halperin's analysis does not appear to have taken these harder cases into account, readers who are concerned primarily with the harder cases are likely to reject his analysis too quickly. When Professor Halperin ignores the variations among contingent liabilities, he may make it too easy for critics to reject his conclusions as extreme.

II. SUMMARY OF PROFESSOR HALPERIN'S CONCLUSIONS

Professor Halperin would require that buyers assuming contingent liabilities include the expected value of the liabilities in the basis of the assets acquired at the time of the acquisition.³ If the payment on the liability is made "as expected," no further deduction would be allowed, even for an interest component.⁴ This treatment differs from the accepted treatment of assumed fixed liabilities, in that when fixed liabilities are assumed there is both immediate basis available for the use of the loan proceeds and an allowance for interest,⁵ frequently taken as such interest accrues, and certainly taken no later than payment. This proposed treatment for contingent liabilities is a variant of the device familiar to readers of Professor Halperin's earlier work involving surrogate taxation.⁶

Professor Halperin also acknowledges that an equivalent result could be obtained by allowing the buyer full deductibility of any amounts actually paid when they are paid, but only after requiring, somewhat artificially, inclusion of income either at the time of the sale or, with an adjustment for the passage of time, at some later time. (The equivalence of these choices and the options available when payments are not made as expected are explicated more fully below.)

3. Halperin, *Assumption*, supra note 1, at 688-700, 711.

4. *Id.*

5. This allowance is generally a deduction, unless the nature of the project is such that interest should be capitalized. Throughout these remarks, "allowance of a deduction" will be used, unless indicated otherwise, on the assumption that the item is one that would have given rise to a deduction no later than when paid if no transfer of assets had occurred.

6. Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 *Yale L.J.* 506 (1986) [hereinafter *Halperin, Disguise*].

At the heart of Professor Halperin's analysis is his demonstration that allowing the buyer a deduction for an assumed contingent liability plus interest when payment is made would be equivalent to allowing the buyer a deduction for the liability at the time of the sale. Therefore basis credit should be allowed only for the liability itself (with adjustment if this allowance is deferred), with no additional deduction for interest paid. He demonstrates this equivalence by first pointing out the windfall that would accrue to the seller of a business if it were allowed a deduction for the interest paid on a fixed, but as yet undeducted liability, such as deferred compensation. This is the context in which surrogate taxation has been most readily accepted, and is not surprisingly Professor Halperin's starting point.

Professor Halperin's reasoning is straightforward and familiar. If an employer and an employee agree to defer for one year payment of compensation (Professor Halperin uses \$100) for work already performed, the tax rules should leave them (considered together) no better off than they would be if the compensation were paid currently. Presumably the employee could have earned interest on the compensation only at the after-tax rate of interest. Therefore the employee could have taken the money, paid tax on it and invested the rest, and, assuming a 40% tax rate and a 10% interest rate, ended up after one year with \$63.60 [net wages: $\$100 - (\$100 \times .40)$] + [net interest: $(\$60 \times .10) - (\$60 \times .10)(.40)$]. Given that the employer which defers payment need only equate the employee's situation with this \$63.60 result, it need only pay \$106 at the end of the year ($\$106 - (\$106 \times .40) = \$63.60$). Therefore the employer must not be allowed to deduct the compensation as if it had been paid or to deduct a pre-tax interest amount, because then it could earn more than it logically should be required to pay the employee. (If it invests the unpaid \$100 at 10%, and pays tax on the \$10, it will have \$106 to pay the employee. If it has any better tax treatment, it will be able to deduct the tax savings and earn more.) The employer can be allowed only a deduction for this \$106, the amount originally owed with an adjustment for the deferral. This adjustment for the deferral gives the employer a deduction of \$106 at the end of the year, a deduction which has the same value to the employer as a deduction of \$100 at the time the compensation was earned.⁷

The lesson demonstrated is that so long as the employee is not taxed as the compensation is earned, the employer cannot be allowed a deduction as the compensation is earned without producing a lower tax burden simply as a result of the deferral of payment.⁸ This lowering of the tax burden is

7. Halperin, Assumption, *supra* note 1, at 678-81 (relying on Halperin, Disguise, *supra* note 6, at 511, 522-23).

8. Under Professor Halperin's approach, as is generally the case under current law, the deduction is allowed when the payment is made. The amount allowed as a deduction is greater than the amount that would have been allowed at the earlier time. This larger deduction

prevented by giving the employer a deduction for the full amount of the payment only at the time of payment, and not allowing the employer to accrue and deduct interest. This deduction of the amount actually paid effectively compensates the employer for the delay in its deduction because, assuming unvarying tax rates and the use of the correct discount rate, a deduction of the future value of any given payment will have the same economic effect as a deduction of the present value of the payment in an earlier year.⁹

This same principle must be followed when the employer's business is sold in a taxable transaction, and the obligation to pay the employee is assumed by the buyer. The buyer's liability must be treated in a way that requires him to set aside an amount no less than the seller would have had to set aside to provide the employee with an after tax amount of \$63.60. The treatment that produces this result requires the buyer to add the amount paid to the basis of the assets acquired when it is paid, or in the alternative, to add the present value of the liability to the basis of assets acquired. In either case, there should be no further deduction when the amount is actually paid.¹⁰

III. WHY IS A BANK LOAN DIFFERENT FROM A CONTINGENT LIABILITY?

The deferred payment (and related contingent payment¹¹) situations are to be contrasted, in Professor Halperin's analysis, with the situations involving the proceeds of an ordinary bank loan. In the case of an ordinary bank loan, the amount of the proceeds are generally available to be deducted (or added to basis, depending upon the use of the proceeds) when received and used; amounts subsequently paid to the lender for the use of its money are deductible as interest. If a buyer of the business assumes this bank

compensates the employer for the deferral of its deduction. It is in ordinary circumstances the same as the amount that would be allowed if the employer were allowed a deduction for the original amount, together with an additional element of interest at the implicit after-tax rate.

9. In the ordinary case, the correct interest rate is the rate that the taxpayer could earn after-tax. Thus, if the after-tax discount rate is 10%, a deduction of \$91 in year 1 will have the same economic impact as a deduction of \$100 in year 2 or \$110 in year 3. Assuming a 30% tax rate, such deductions would give the taxpayer a current benefit of \$27, \$30, or \$33, respectively. The savings in years 1 or 2 could be invested to produce an overall yield of \$33 in year three.

10. Halperin, Assumption, *supra* note 1, at 684-85. The present value for these purposes is computed at the after-tax rate of return, since the buyer will incur tax liability on the interest earned if it has set aside a fund to meet the obligation.

11. "All contingent liabilities fall into the second of the two categories described in Part II—typified by the deferred compensation arrangement—because the seller is allowed no deduction, basis, or other tax attribute until the contingency is resolved." Halperin, Assumption, *supra* note 1, at 688-89.

liability, the buyer is entitled to add the principal amount to basis, and to deduct the interest paid or accrued.¹²

Professor Halperin asserts that contingent liabilities assumed in asset transfers must be treated like deferred compensation because they, like deferred compensation, have not yet been taken into account by the seller.¹³ Ideally, the purchaser should be allowed basis for the expected economic value of the liability at the time of the purchase. In the alternative, an allowance for this amount, adjusted for deferral, should be given when the liability is paid. But in no event should there be a separate deduction for the interest component of the amount paid.¹⁴ If such liabilities had been taken into account by the seller, as the use of the proceeds of a bank loan are, then apparently Professor Halperin would allow a deduction for an interest component.

There is something circular about Professor Halperin's sorting of liabilities into these two classes: those which have given rise to tax attributes for a *seller/obligor* (the classic bank loan that bears interest) and those which have not (the compensation payment which has been deferred). The fact that the proceeds have been taken into account by the seller/obligor should not, in itself, be a reason for distinguishing between these two types of liabilities. The real distinction between these cases is the prior fact that the typical lender will have lent after-tax funds, while the typical employee will be deferring tax on the deferred payment, and will therefore, in effect, have lent before-tax funds.

12. In the body of the text, Professor Halperin does not consider the question of how much interest on such liability should be deducted or when it should be deducted. These issues are considered only in the abstract, in Appendix I. Halperin, Assumption, *supra* note 1, at 712-14. In theory, only the present value of the liability, calculated using the after-tax discount rate of the buyer, should be treated as the liability assumed by the buyer and added to the basis of the assets purchased. Unless there is a renegotiation of the debt, however, the terms of the debt will not be restated, and the tax accounting for the assets purchased will produce imperfect results. If the discount rate faced by the buyer is higher than that faced by the seller when the debt was first incurred, the seller will have gain relating to the debt mischaracterized as gain on assets, and the buyer will have an overstated purchase price and an understated interest cost. If the discount rate faced by the buyer is lower than that faced by the seller when the debt was first incurred, the seller should have a loss relating to the debt, and the buyer will have an understated purchase price and an overstated interest cost. (This summary assumes that the buyer's burden should be the measure of the seller's gain or loss on its debt position. Other more complicated approaches could be used.)

13. Professor Halperin outlines these two classes of liability in Halperin, Assumption, *supra* note 1, at 676-77.

14. Halperin, Assumption, *supra* note 1, at 684-86.

One can ordinarily assume that loans are made with funds that are after-tax to the lender.¹⁵ When the loan proceeds are transferred to the borrower, there is no additional value added to the tax base. There has only been a transfer of previously included values. Therefore the transfer of the funds can be ignored without omitting any values from the overall tax base.¹⁶ As a normative matter, interest on this ordinary bank loan will be deductible to the payor. There is no reason not to allow a deduction of interest on amounts that represent earnings on values that have already been taxed, especially when, in general, these interest earnings can readily be taxed to their owner, the lender.¹⁷ There is no untaxed principal, and no untaxed interest. Since both parties will be aware of this treatment, the negotiated interest can be assumed to be stated at a pre-tax rate.

On the other hand, the typical employee has not yet taken into income the amount that he is, in effect, lending the employer. To the extent that this value has not yet been accrued, there has been a value omitted from the overall tax base. In Professor Halperin's deferred compensation situations, for instance, the earned compensation should have been taxed to the employee. Because it has not yet been taxed to the employee, the employer's deduction is deferred until payment. When the compensation is paid, both the employer and the employee are taxed in ways that put them in the same position that they would have been had the compensation been paid and accrued earlier. The employer is allowed a deduction that includes an interest-like increment to make up for the deferral of the deduction for the payment, and the buyer similarly must take into account an amount that includes an interest-like increment to make up for the deferral of the inclusion. Because the employer will, in fact, be paying the employee's income tax on the interest on the not-yet transferred fund, the employer and employee can be

15. Not all loan proceeds are made with values that can be assumed to be after-tax. For instance, sales with deferred payments that are accounted for on the installment method, amount to loans of pre-tax values. The interest charge under § 453B, and the rules precluding installment treatment of recapture gain under this section have substantially limited the circumstances in which loans can be made with pre-tax proceeds. Similarly, before the 1984 changes to the methods for reserving for bad debts, some lenders could effectively deduct a substantial part of their loan proceeds, making them effectively pre-tax to that extent.

16. It appears that Professor Halperin would be willing to allow the retransfer of such after-tax funds, even when a traditional loan is not involved. Professor Halperin simply assumes that the proceeds of a bank loan can be retransferred to a third party without the third party taking the amount into income. Halperin, *Assumption*, supra note 1, at 682 n.19.

17. If interest is not charged to the lender, only the interest deduction should be subject to the same surrogate taxation device. A deduction should be allowed not as interest accrues, but only as it is paid or taken into account by the lender. No adjustment needs to be made to account for the principal, since it has already been taxed to the lender, and has not been deducted by the lender on the transfer to the borrower.

assumed to have agreed that the interest-like increment should be accruing at an after-tax interest rate. Under these assumptions, the allowance of deferred deductions for principal, with compensation to the employer for this deferral, is appropriate.¹⁸

In sum, I believe that the criterion Professor Halperin chooses to focus on, whether the liabilities in question have given rise to tax attributes for the seller/obligor, does not provide the true distinction between these two types of liabilities. The link identified by Professor Halperin between the seller/obligor's tax attributes and the deductibility of interest is useful only because, in most situations, the rule for allowing the seller/obligor's tax attributes to be taken into account provides a good substitute test for determining the likelihood of prior income inclusion by the effective lender. There is much in the relevant tax accounting rules that conditions the seller's ability to take a deduction into account upon the likelihood that the ultimate recipient has taken the amount into income. The fact that the amount has been taken into account by the seller is only a likely indicator of the fact that the ultimate recipient has taken the amount into income. Both the granting of tax attributes to the seller and the allowance of an interest deduction are conditioned on the likelihood that the ultimate recipient has taken the amount in question into income, and that, therefore, no amount has been omitted from the tax base.

Surrogate taxation is only necessary when values that should have been included in the tax base will remain excluded or their inclusion is deferred. Deferred payment for values previously created by an employee, in effect, leaves those values out of the overall tax base during the period of the deferral. Professor Halperin's surrogate taxation compensates for this omission from the tax base (and the fact that the taxpayers can earn interest on what would have been paid in taxes). In Professor Halperin's compensation example, the \$100 of compensation will be omitted from the tax base from the time that it was owed to the employee until the time that it is paid. The employer, therefore, can earn the interest on what could be viewed as the government's share of that \$100, or \$40 (assuming a 40% tax rate.) The government can reclaim this lost interest by, in effect, taxing the earnings of the \$100 twice, once as it accrues in the employer's hands, and again on payment to the employee. Thus, the \$10 earnings taxed once at 40% leaves

18. Halperin, Assumption, *supra* note 1, at 679; Halperin, Disguise, *supra* note 6, at 519-24. Professor Halperin's preference for characterizing the deduction as a grossed-up deduction for principal with no deduction for interest allows one to understand his underlying analysis more clearly. Unless there is a difference between the interest rate that is appropriate when compensating the payor for the delay in the deduction and the interest rate that is appropriate when calculating the interest rate charged by the payee, the results are the same no matter how the deduction is characterized.

\$6, and taxed again leave \$3.60. This \$3.60, combined with the after-tax amount available to the employee after payment, leaves the employee with \$63.60, the same amount she would have had available had the compensation payment not been deferred.¹⁹

In sum, the real distinction between the bank loan and the deferred compensation cases is not whether the seller/obligor has been allowed to take the liability into account, but the prior fact that the typical bank lender will have lent after-tax funds, while the typical employee will be deferring tax on the deferred payment. In the case of the bank loan, there is no reason not to allow the liability to be taken into account immediately and allow a deduction for interest. In the case of the deferred compensation, the seller's treatment must reflect the fact that the employee has not taken the payment into income.

IV. THE PREMISES UNDERLYING SURROGATE TAXATION

As the prior analysis reveals, the starting point for Professor Halperin's analysis is the need to protect the tax base from inappropriate omissions that can result from discrepancies in the timing of deductions by payors and inclusion by payees. The importance of these insights (and Professor Halperin's contributions to their acceptance and implementation throughout the Code) cannot be overstated. Nevertheless, it is useful to consider the premises on which the approach relies, and to consider the circumstances under which it is appropriate to extend principles of surrogate taxation beyond Professor Halperin's deferred compensation examples.

The first premise is that there is one ascertainable point in time at which to take into account any value includible in the income tax base and that, starting with this point in time, it can be assumed the value could have generated an additional interest-like return that the payee is in fact claiming. The second is that all values, once created, remain in the system, either in their original form or as inputs to the production of some other value, and that they remain available as a source of an additional interest-like return. Both of these premises are true frequently enough that they appropriately constitute a starting point for discussions of timing in tax accounting; neither are so universally true that the possibility of their nonapplicability should be totally ignored.

19. If the deferral were for two years, the amount left for the employee after current payment and taxation would have been \$67.42 ($\$63.60 + (\$6.36 - \$2.54)$). To leave the same value in the hands of taxpayers, the employer must be taxed on the earnings as they accrue (leaving \$106 at the end of the first year and \$112.36 at the end of the second), with the entire amount taxed to the employee on receipt ($\$112.36 - (\$112.36 \times .40) = \$67.42$).

The limits of the first premise—that there is no ambiguity about the precise time at which a value can be said to exist, and that an interest-like return is therefore accruing untaxed—can be demonstrated by moving from questions regarding employee compensation to self-created assets. Suppose a farmer harvests 400 bales of hay at a time when hay costs \$3 a bale. He stores the hay in his barn, expecting to feed it to his own livestock.²⁰ Although there has been \$1,200 of value added, it is a value that the tax law does not attempt to include in the tax base.²¹ (This exclusion may be theoretically wrong, nevertheless, the tax law has never thought the problem to be so significant as to require the extraordinary efforts necessary to overcome the administrative problems inherent in trying to include them.)

The farmer will be taxed on the value that he has added through producing the hay, but only if and when he sells his livestock. Only at that point will tax accounting acknowledge the value he has created. No existing tax accounting rules will attempt to make up for the failure to tax the value the farmer added to the economy but did not commit to the market, even though several years may have passed while the hay was stored in his barn. Furthermore, if he feeds the hay to his son's show pony, the value will never be accounted for.

Suppose instead that a drought hits a neighboring region. The owner of a racetrack is attempting to secure as much hay as he can, and contacts the farmer. The farmer agrees to ship 400 bales the next day for \$3.50 a bale. The farmer has \$1,400 (400 x \$3.50) of income (no later than when he is paid), and the racetrack has \$1,400 of deduction (assuming the hay will be consumed within a relatively short period of time.²²) The farmer, like Professor Halperin's employee, should have income at this point in time, and any arrangements between the farmer and the racetrack owner to lessen the

20. Hay was deliberately chosen as a crop for which the most substantial contributions to the added value can be assumed to be the farmer's own land and labor, with relatively few purchased inputs. Under the assumption that there are few purchased inputs, questions regarding the timing of the deductions for the purchased inputs can be avoided. If there are substantial purchased inputs, it is likely that they should not be allowed unless and until the farmer recognizes gain with respect to the hay.

21. The text does not attempt to address the underlying question whether, as a normative matter, the income tax should tax all accretions to wealth or all accretions to wealth that are transferred in the market. Since it is clear that the current tax law omits virtually all wealth unless it is committed to the market, it seems appropriate to use that norm here. The ambiguity identified in the text, however, exists even assuming this norm. See, e.g., Noel B. Cunningham & Deborah H. Schenk, *How to Tax the House that Jack Built*, 43 *Tax L. Rev.* 447 (1988).

22. Note that if the farmer does in fact divert self-created value from nonmarket to market use, he should be entitled to take into account his after-tax investment in such value. There is no norm, however, for determining whether he is entitled to take such costs into account as of the time the investment was made, or as of the time of the conversion.

tax burden through payment arrangements are properly subject to surrogate taxation.

Suppose instead that, on learning of the drought, the farmer suspects that hay will become even dearer than it is now, and he is unwilling to part with his hay so soon at such a low price. He agrees to ship the 400 bales now, but insists on being paid an amount that will vary depending upon the level to which market price of hay eventually rises. That price will not be determined until the next taxable year. Should the farmer have income at the time the deal is struck? Probably, for at this point, the farmer is essentially the same as Professor Halperin's employee. Assuming that this is correct, for what period, and for what amount will surrogate taxation be appropriate? Should we attempt to tax the farmer the same as if he had agreed to sell the hay at the time when it was first baled? It seems unlikely that the later decision to take the hay to market should affect the treatment of the time that passed before the decision to go to market, but it would not be incoherent to do so.²³ Or should we attempt to tax the farmer as if he had agreed to the spot price at the time he agrees to sell to the owner, and require surrogate taxation from that point and measured from that value? This seems far more appropriate and certainly more consistent with current law. The reason is that, once the farmer is dealing with the owner, we can assume that he is in a position to charge interest for the delay in payment and that the racetrack owner's use of the hay will allow him to pay such interest. Until that time, we could not be sure that the farmer could command any price, much less a price with interest, for his hay. After that time, the presumption that he could charge interest seems more appropriate.²⁴ Because the farmer and the owner have control over the terms of their agreement, it may be appropriate to assume that they have consciously agreed to defer payment, and that surrogate taxation is therefore appropriate. But the first premise behind surrogate taxation (that payees can all command an interest-like rate of return on all values from their initial creation) is likely to be met only after the farmer and the owner strike a deal.

The second premise vital to surrogate taxation is that all values once created are never destroyed. These values are instead always used up in the course of creating other values or consumed in a way consistent with their remaining in the tax base. Therefore transferors of value can be assumed to

23. In this example, if the later market transaction affected the taxation of earlier events, the payment, when ultimately made, would be viewed as a lower price, but with a higher rate of interest charged.

24. The text ignores one troubling complication. Is any future increase in the price of the hay a separate asset, which, as a normative matter, need not have been included in the tax base as of the time the deal was struck, or is it part of the value that the farmer is effectively deferring?

be implicitly charging interest, because those to whom they have transferred value will in turn put that value to further productive use.²⁵

If the farmer sells to the racetrack owner, the owner will presumably buy the hay only if he can expect to use it to create other values. The farmer's labor has produced the value of the hay, and presumably this value will be used up in the course of the operations of the racetrack. Without surrogate taxation, the value of the hay could be kept out of the tax base by deferring payment to the farmer so long as the farmer is willing to accept the owner's credit. Without surrogate taxation, both parties can benefit from arranging their affairs to take advantage of this omission. Therefore, in the ordinary case, the owner should not be able to take into account the cost of the hay until the farmer has included it in his income.

But what if the weather changes abruptly and an undetected leak in the racetrack owner's barn renders the hay useless? From the point of view of the overall tax base, there are no more values that should be included than there would be if the farmer had never produced the hay. Although he has not ultimately received anything in return, the owner must still pay the farmer next year based on hay prices in the interim.²⁶ To replicate the tax base that would have been available had the farmer never produced the hay, we would have to allow the owner to transfer a fund of cash to the farmer without any net diminution by tax.

There are no current tax accounting norms that inform us which point of comparison—as if there had never been any hay or as if the hay continued to have value—is correct. The problem lies in the failure of income tax theory to define precisely when realization is normatively appropriate. On the one hand, the government's claim to a share of the earnings from a fund (the hay) that no longer exists seems tenuous. If realization is appropriate only when values are sufficiently concrete that they can be presumed to be commanding an interest-like return, then the never-any-hay baseline is by analogy most appropriate for the destroyed-hay situation. On the other hand, if cash had been paid by the owner initially, the government would have received its share earlier, and the earnings on this share would not have been contingent on the fund's ability to produce such a return.

25. Owners of self-created assets could also be assumed to be implicitly charging themselves interest as they await the sale of the second stage of self-created assets. Thus, in the normal course, the farmer bales the hay under the expectation that his later livestock sales will provide him adequate compensation for the labor and incidental costs that he incurs while baling, plus a modest rate of return for the delay in receiving such compensation. His behavior, however, is equally consistent with being unable to anticipate a price sufficient to justify the additional costs of bringing the hay to market.

26. Note that to the extent that the owner actually bought the hay as insurance against the possibility that he would not be able to obtain hay, the treatment suggested by the text would undertax the overall transaction.

Any difference between taxation of the farmer and the taxation of the employee is attributable to reliance on notions of realization. Professor Halperin's invocation of surrogate taxation is premised on the notion that values created through waged labor should be realized as the employee exchanges labor for a promise to pay. In a realization-based income tax, the norm for the inclusion of gains on property is generally to ignore new value (as well as increases and decreases in previously included values) until it is subject to a market transaction, regardless of the circumstances under which it arose. The value of self-constructed assets, like the farmer's hay while it remains in the farmer's barn, does not fit easily into either category. The destruction of the purchased hay brings the norms for wage income (and the need to tax the farmer currently) into conflict with the norms under a realization-based income tax for asset income (which tolerate deferrals of both gains and losses).

V. WHAT IF THE SELLER'S DEFERRAL HAD NOTHING TO DO WITH SURROGATE TAXATION?

Professor Halperin ably demonstrates that in the most common situations, allowing a buyer a deduction for that part of a payment attributable to a contingent liability in effect accelerates the deduction of the liability compared to the treatment that the seller would enjoy if the business assets had not changed hands. When such treatment is allowed and the economic effect is analyzed taking into account the timing of the deductions involved, the buyer is effectively allowed to deduct the amount as of the time of the transfer of assets and liability assumption, when ordinarily the seller's deduction would have been required to await payment. If an assumed contingent liability represents a value received by the seller and not yet included in the tax base, such an acceleration is, as Professor Halperin demonstrates, inappropriate.

Professor Halperin also acknowledges that there may be circumstances in which there is no need for surrogate taxation, because the ultimate payee is not deferring income and there is no value remaining omitted from the tax base.²⁷ However, he asserts that these can only be situations in which the seller's deduction is being delayed without warrant. If the seller's deduction is delayed without warrant, he asserts, the rule requiring the seller's deferral should be changed, not the treatment of the liability assumption in connection with a sale of assets. Implicit in his discussion is the notion that the sale of a business could not justify a change in the timing of the deduction:

27. Halperin, Assumption, *supra* note 1, at 694.

The potential payees of some contingent liabilities may not be deferring tax on the corresponding income. Without an income deferral, the payor could possibly be allowed the equivalent of an interest deduction. However, if, in the absence of the sale of the business, the seller's deduction for the item would have been delayed until payment, it effectively does not get an interest deduction in connection with the payment of contingent liabilities. If this treatment is considered unwarranted, it should be corrected whether or not a sale takes place. I see no reason for a different result merely because the business has been sold. Thus, if the seller would not get an interest deduction, neither should the buyer. The entire payment should be nondeductible.²⁸

This comment should give the reader familiar with the notion that a sale is ordinarily a realization event some pause. After all, sales do make an enormous difference in a realization-based income tax, for many losses will be allowed only upon a sale. If the contingent liability in fact represents a net loss to the tax base (rather than a deferred payment for value added in connection with the transaction in question), there is no reason that the overall tax treatment of the liability should not be more favorable as a result of a sale.

It is not hard to imagine situations in which sellers have previously unrealized losses triggered by the sale of a business. Suppose the seller had, in the course of conducting its business, caused the contamination of the soil on land it owned. (Assume for the moment that there will be no accompanying obligation to clean up the soil, but that the land is clearly worth less than it would otherwise be, and that it is worth less than its basis in the seller's hands.) Surely the sale of the land would be an appropriate time to recognize this loss in value. Indeed, an argument could be made that an allowance of the loss only on a sale does not provide the seller with an adequate tax treatment of the lost value. Perhaps a more technically correct treatment (absent the traditional limitations of realization) would have been to allow the seller to take this loss in value into account as the seller took into account its income from the use of the land. Nevertheless, the seller will in fact take this loss into account on the sale, and only because of the sale.

It seems to me that there are at least two situations in which an obligation to pay in the future is tantamount to an unrealized loss that could appropriately be triggered by a sale of a business. Both involve an appropriation by the seller/obligor of value that has unquestionably been destroyed or

28. *Id.*

committed to a use that will produce no future value for the seller or buyer as of the time of the sale. Suppose, for instance, that instead of contaminating its own soil, the seller/obligor had inadvertently caused the destruction of some of the value of its neighbor's land. Although the degree of damage has not been determined yet and the neighbor's ultimate recourse has not yet been established at the time of the asset transfer, the seller/obligor clearly will be ultimately liable for some sort of damages at the time of the sale. How should the neighbor be viewed for tax purposes? Has she merely transferred new value to the seller/obligor for which she has not yet been compensated, just as the uncompensated employee had in Professor Halperin's initial analysis? If so, Professor Halperin's analysis seems appropriate. Or is it possible that something less susceptible to Professor Halperin's analysis has occurred?

The assumption that the underlying events that gave rise to the contingent liability produced value, which will be omitted from the tax base unless the neighbor is taxed directly or through surrogate taxation, simply may not hold. The neighbor will likely have suffered a decline in value in her land. This value may be replaced by the later payment by the seller, perhaps with interest. The transaction can be viewed as essentially a forced loan of value from the neighbor to the seller/obligor. So long as the value appropriated by the seller from the neighbor was an after-tax value, there is no obvious reason not to accord the entire transaction the same treatment given to a more conventional loan. Under this treatment, the seller/obligor should be accorded a basis allowance for the use of the loan proceeds at the time they are extended, and the interest component should be fully deductible. If the seller/obligor's actions had caused an absolute loss reasonably measured at \$100 of after-tax values owned by the neighbor, and if the seller/obligor has no future value left to show for these appropriated values, this amount should be deductible to the seller. When this amount, plus 10% interest, is repaid to the neighbor a year later, an additional deduction of \$10 should be allowed. Under Professor Halperin's reasoning, so long as the loan is of after-tax values, the seller/obligor should be allowed an immediate deduction for the use of the "loan proceeds" (so long as the equivalent purchase would have been deductible), and for interest later paid.²⁹

Anything less than this would, under Professor Halperin's own analysis, result in overtaxation.³⁰ The rules for taxing any delayed payment by the seller/obligor should ensure that the same economic burden is imposed

29. *Id.* at 693-94.

30. Again, the astute reader will discern that this overtaxation is the same overtaxation inherent in realization limitations on taking losses into account. The argument is essentially that surrogate taxation is not appropriate when the ultimate recipient has unrealized losses, or indeed, that surrogate realization of losses is no less appropriate in certain cases than surrogate realization of income.

on the seller in order to achieve the same net effect on the neighbor as if payment had been made at the time of the loss. If the seller/obligor had paid the neighbor immediately upon the destruction of the property, the neighbor would have received \$100, totally offset by basis. If this amount were then invested at 10% with a 40% tax rate, the neighbor would have \$106 at the end of the second year.

But the neighbor's use of basis in the destroyed property will be delayed when she is only allowed to use it as an offset to the proceeds she receives in year two. The rules chosen for the seller/obligor's deduction should therefore in effect allow a surrogate for the delayed use of the neighbor's basis in the destroyed property. Without a deduction in the first year, the seller can set aside only \$60 of the \$100 that it might have paid initially, which will earn \$6 before tax, and the seller will enjoy a tax benefit of \$40 in the second year. The seller will therefore be able to transfer \$106 to the neighbor. But the deferred use of the neighbor's basis will shield only \$100 of the payment, and she will be left with only \$103.60. If the seller/obligor is allowed a deduction at the time of the destruction, it can set aside the full \$100, and earn \$10, which, when paid to the neighbor, will put the neighbor in the same position as if she had been paid (and allowed to use her basis) immediately.

Note that the same result can be reached by acknowledging the loss when it first occurs by giving the neighbor an immediate deduction for her loss, without regard for the possibility of payment, and deferring the seller/obligor's deduction. (This treatment is not generally allowed because of the possibility of reimbursement.³¹) A deduction of \$100 at the time of the destruction would have produced a tax benefit of \$40, which would earn after-tax interest of \$2.40 after a year has passed. Again, without a deduction, the seller/obligor will only be able to pay \$106 in the second year. But the receipt of \$106 without basis offset in the second year would have produced a net after-tax receipt of \$63.60, for a total after-tax position of \$106.

The above analysis simply demonstrates that at least some contingent liabilities may be the result of absolute losses to the tax base, not just transfers of values new to the tax base, for which no tax accounting has yet been made. These liabilities arise under circumstances best understood as a forced borrowing coupled with a destruction of the loan proceeds. When a liability arises from the destruction of after-tax values, the transaction could be given a tax treatment no more onerous than that accorded to bank loans. As Professor Halperin himself has argued, the fact that the liability is contingent, whether because the seller's liability is not clear as a matter of

31. See, e.g., Regs. § 1.165-1(d)(2); *Halliburton Co. v. Commissioner*, 946 F.2d 395 (5th Cir. 1991).

law or because the extent of destruction cannot be ascertained, should not be determinative of its appropriate treatment. The determinative factor should be whether the overall transaction involves a deferral of the inclusion of a value in the overall tax base (as Professor Halperin's compensation entails) or a deferral of a deduction for a loss to the overall tax base (as in the case of the contamination of the neighbor's land.)

In other situations, the loss may not be of values already taxed, and yet a sale may nevertheless be an appropriate time to take a loss into account. Reconsider the case in which the seller/obligor had contaminated its own soil and not that of a neighbor. Assume that there is no obligation to replace the wealth of another, but the seller/obligor has an obligation to clean up the soil in the future. The seller/obligor's business would clearly be worth less as a going business as a result of this future obligation. Barring some special treatment, however, this loss would be deferred for tax purposes until payment on the obligation was made.³² Would it nevertheless be appropriate to take this loss into account at the time the business is sold? Is a sale supposed to make a difference with respect to the aggregate tax treatment of such unaccrued liabilities?

Existing law provides surprisingly little guidance with respect to this question, partly because the occasions in which unaccrued liabilities are in fact sold or otherwise subject to clear-cut realization events, outside of sales of businesses, are few. (The fanciful nature of the following should serve as an indication of how unlikely it is that the issue in question will be starkly raised, outside of the context of traditional debt instruments.) Imagine that A was a roofing contractor, and after completing various jobs was obligated to provide for the repair of many of the roofs in her neighborhood. Assume further that with each year that passes, it becomes more and more likely that a roof will in fact fail, and a claim on A will be made. B, also a roofing contractor, was similarly obligated with respect to all of the roofs in his neighborhood, 500 miles away. Although both have booked all of the income associated with these jobs, neither uses an accounting method that allows any reserve for the future work that may be necessary. Suppose further that they both decided to move, and swap repair obligations as well as neighborhoods. Has there been a realization event with respect to these liabilities?

There clearly has been a change in legal obligations: entirely different people now have claims against A and B. How does the possibility of such

32. For further consideration of the appropriate treatment of this sort of future liability to the seller, see Halperin, *Disguise*, supra note 6, at 528-31; Donald W. Kiefer, *The Tax Treatment of a "Reverse Investment": An Analysis of the Time Value of Money and the Appropriate Tax Treatment of Future Costs*, 26 *Tax Notes* 925 (Mar. 4, 1985); Emil M. Sunley, *Observations on the Appropriate Tax Treatment of Future Costs*, 22 *Tax Notes* 719 (Feb. 20, 1984).

a swap triggering realization of gain or loss with respect to these liabilities mesh with traditional timing rules for taking into account liabilities? Can such economic burdens be “realized” as the result of a sale before the traditional all events test has been met, or before the standard for economic performance under section 461(h) has been met?³³ Can they be viewed as “anti-assets,” the existence of which should be acknowledged at the time of a sale?³⁴

The answer may well be that they should not. Note, however, that if A and B had been entitled to payments from their former customers as each year passed in which their roof did not leak, arguably a swapping of such rights should be treated as a realization event with respect to an asset.³⁵ The important point here is that Professor Halperin overlooks the possibility that the transfer of position that requires a future payment could appropriately be viewed as a realization event with respect to a position that is tantamount to an “anti-asset.”

Perhaps such “anti-assets” could be acknowledged in those limited situations in which an unpaid loss to one taxpayer definitely will not give rise to an increase in wealth to another taxpayer. If such “anti-assets” were acknowledged, there is no reason not to allow the seller a deduction at the time of the sale. Returning to the contamination of the land example, the only real point of dispute should be whether this loss should be measured by an abstract notion of the decline in the market value of the land (and thus

33. The application of § 461(h) in the hypothetical may be problematic: the taxpayer has performed, and been paid for, the original roof work, but must, if claims are made, provide or pay for additional services. The transfer of these additional services will have no tax effect on the recipients, who are treated as merely having received something for which they have already paid. (Note that this fact distinguishes the hypothetical from the superficially similar *Mooney Aircraft* case, in which the warranty involved the payment of cash. *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400 (5th Cir. 1970). Most observers would conclude that the payment of a Mooney bond would be an event that must be taken into account for tax purposes, since the recipients were to receive cash. It is much less clear whether there would be agreement regarding what that tax treatment should have been.)

34. This question is related to, but not the same as the question of whether gains or losses on previously accounted for liabilities should be taken into account. Section 1274(c)(4) suggests that liabilities associated with single assets are not to be taken into account upon the sale of those assets. This rule will characterize the gains and losses, but will not otherwise mismeasure income. This treatment can result in mismeasurement of income when combined with other accounting anomalies. See, e.g., Charlotte Crane, *The Effect of Market Discount and Premium on the Measure of Corporate Gain on Liquidation Under Section 336*, 17 J. Corp. Tax'n 119 (1990).

35. If the position were an asset position, the amount taken into income as a result of the exchange would become basis, and, if later payments received exceeded this amount, the excess of payments over basis would be income. If the position were an anti-asset position, the excess amounts over the amount originally deducted should be deductible at future realization events.

limited by the pre-contamination value of the land) or by the total economic burden that the future payments represent. (Note that there is no reason to assume that these two amounts will be equivalent.) Although rules allowing a deduction for the loss at the time of the contamination might appropriately take into account whether the seller/obligor had adequate basis in the land and in other assets that would bear the economic burden of cleanup, there should be no such problem at the time of the sale, when, presumably, all of the gains in properties held by the seller will be recognized. As of the time of the sale, any value against which the claims might be made can be assumed to be after-tax.

Note that in the contaminated land situation, there is no particular reason to look to the tax treatment of the ultimate recipient to determine the appropriate tax treatment of the overall transaction. This as yet unidentified taxpayer will not be compensated for values "lent" to the seller/obligor at the time of the contamination. She will, instead, be compensated for values that she creates and that are essentially new to the tax base as she performs the cleanup. There is no untaxed principal owed to her when the future payments can first be predicted, nor is there any untaxed interest in the interval between the contamination and the cleanup payments.

These cleanup payments are very different from Professor Halperin's deferred compensation payment, the tax treatment of which must be deferred until the recipient takes the compensation into income. The seller/obligor is *not* denied a deduction for the future payments only because the taxpayer that will perform the cleanup has not taken the amount into income. The seller/obligor is denied the deduction for the cleanup payments primarily because the loss in value represented by the future obligation is too vague to be taken into account.

Since the only reason the seller was denied a deduction for such anticipated payments prior to a sale is because the liability simply was too amorphous to be "realized" prior to a sale, should a sale, the classic moment at which gains are to be "realized," also be a presumptively appropriate time for "realizing" losses?³⁶ Surely the problem cannot be that the loss cannot be quantified, since Professor Halperin himself relies on being able to quantify the loss at the time of the sale. Professor Halperin's deferred

36. The reader should not lose track of the fact that although the cash sales price will of course reflect the economic burden of the cleanup expense assumed by the buyer, this lowered cash amount will not guarantee a tax result equivalent to loss recognition, because ordinarily the liability for the future payment assumed will be included in the seller's amount realized. As Professor Halperin's analysis reveals, tax treatment equivalent to recognition of the seller's loss at the time of sale can be achieved in several ways, either by explicitly allowing the seller the loss, or by adjusting the buyer's accounting for payments on the liability. See Halperin, Assumption, *supra* note 1.

compensation case clearly does not represent such a loss; the employee presumably added value to the employer's enterprise and his compensation is in effect a sharing of that value. To allow a deduction for payment without including an amount in the employee's income would, in effect, keep that value out of the overall tax base during the period of deferral.

There are two other types of contingent liability for which Professor Halperin's insistence on taxation of the seller/obligor to make up for the failure to tax the ultimate payee may not be appropriate. In these situations, there may be considerable doubt about whether the ultimate recipient should ever be taxed upon payment. The first type of contingent liability involves payment of amounts that, for various reasons, under ordinary circumstances are not included in the income tax base of the recipient. Potential tort judgments frequently represent values that have already been destroyed, in the form of the physical integrity of individuals who have been injured but who have not yet made claims. These ultimate payees do not have basis in the ordinary sense in their physical integrity. But they do not have to include amounts in income when they are compensated for an impairment of this physical integrity by a third party who acted wrongfully. In such cases, surrogate taxation of the seller/obligor serves only to limit the exclusion that is otherwise allowed. Although it is highly likely that this limitation is appropriate (since otherwise taxpayers can arrange for deferred payment in order to maximize this exclusion), there is no easy answer to the question whether, as a normative matter, the tax law treats the amounts lost by tort victims through "forced loans" to tort-feasors as before- or after- tax values.

The second additional type of contingent liability also involves doubt about the propriety of insisting upon including an amount in the recipient's income before a deduction can be allowed to a payor. Many contingent liabilities may in effect be warranty payments, that is, payments made by the seller/obligor to remedy some shortcoming in the product transferred, unrelated to any measure of particular value transferred by or injury incurred by the ultimate recipient.³⁷ Generally, we do not tax recipients of such payments. Either they are only being paid a return of capital, or they are enjoying what is in effect a bargain purchase, since the price that they paid may not have accurately reflected all of the seller's costs. This tax treatment may not always be correct, since there may be circumstances in which there

37. Frequently such payments are made when there is a discontinuity between the value paid to the seller at some point in the past and the value that the seller has promised to provide in return. The seller may have in effect promised its customers that, in the aggregate, the value of the units it has transferred will approach the average price paid, but that some customers will have received units worth less, and will deserve some sort of rebate. When these ultimate recipients are paid, their receipts may be accounted for not as gains, but as receipts for an amount for which they have already paid.

is an interest component or a component in the nature of liquidated damages for lost profits built into the terms of the warranty. But even if it is not technically correct to leave ultimate recipients totally untaxed, there seems to be no reason to insist on a tax treatment for warranty liabilities transferred in asset sales that assumes that warranty payments should be taxed to the recipients when, generally, that is not the case.

VI. WHAT IS AN ASSUMED LIABILITY?

Professor Halperin correctly points out that perhaps the thorniest issue with respect to the assumption of contingent liabilities is the identification of those payments that should be associated with assumed liabilities and those that should be merely regarded as part of the buyer's operating costs after the purchase.

The answer, it seems to me, is both clear and unworkable. If total purchase price must equal total fair market value of assets, and if transactions that include assumed liabilities are to be accounted for in a way that is as close to a cash purchase as possible, all commitments to make future payments that reduced the amount of cash a buyer would be willing to pay must be counted as assumed liabilities. An assumed liability is therefore any position with a negative net present value, that is, any unavoidable future payment with a present value greater than the present value of the benefits to be enjoyed in the future associated with that payment. (This is simply a more rigorous version of the test proposed by Professor Halperin, that the distinction between an assumed liability and the buyer's own liability is "whether the potential liability relates to past or future income."³⁸) Any such excess burden can be assumed to have been taken into account by the buyer, and produced a reduction in the cash price paid.

Any commitment to make a future payment can have this characteristic, regardless of its resemblance to a period or current cost. An unfavorable loan or rental agreement, indeed, an unfavorable wage rate, is an assumed liability in this sense. If a buyer could have paid \$5,000 a month for very similar rental space, but must take over a lease for \$7,000 a month for the first two years after the purchase of a business, that buyer will pay about \$17,000 less for the assets transferred than he otherwise would have paid. With each rental payment, the buyer is effectively paying \$5,000 of current rent, and \$2,000 of the price for the assets purchased.

The problem, of course, is in associating future payments with potential future benefits. For most payments, there simply is no way to trace payment directly to future benefit, even when the amount of the required future payment is fixed. The payments to be made to Professor Halperin's

38. Halperin, *Assumption*, *supra* note 1, at 690.

employee could be merely compensation for prior completed work, or they could be designed as an incentive for the employee, or as an incentive for other employees, or they, more probably, could be some combination of the three. In this respect, the identification of an assumed liability involves essentially the same calculation as the identification of the component of any expenditure that must be capitalized.

The price a buyer is willing to pay for a business will depend not just on what price the individual assembled assets being purchased could command if sold separately, but what the costs of future operations will be. The apparent price of assembled assets will be reduced if the buyer anticipates greater future operations costs than other buyers might; the apparent price of assembled assets will be increased if the buyer anticipates lesser future operations costs than other buyers might. It seems grossly impractical, however, to try to account for all such discounts and premiums in ways other than they would have been accounted for had the business remained in the hands of the seller.

It may make more sense, however, to try to identify as assumed liabilities those commitments to make future payment that are closely tied to a prior value transferred to the seller under terms that suggest that most of the value to be received by the owner of the assets has in fact been received before the sale of the assets. Only if the value to be received after a sale is negligible should a commitment to make a future payment be considered an assumed liability.

VII. RECONSIDERING THE ALTERNATIVES FOR ACCOUNTING FOR THE ASSUMPTION OF CONTINGENT LIABILITIES

Professor Halperin uses as a starting point the proposition that the sale of assets in which liabilities are assumed should be taxed no differently than the sale of assets in which cash is the only consideration given. In a cash sale, all gain is recognized, and a buyer is allowed cost recovery for the purchase price. Therefore, in order to replicate the treatment of a cash sale, an amount must be taken into income (or an amount paid with no accompanying deduction) with a present value equal to the expected value of the liability,³⁹ and cost recovery must be allowed for this amount as of the time of the sale. (These items will be offsetting, except to the extent that cost recovery is delayed and therefore provides deductions with a present value as of the time of the sale lower than the nominally equivalent income inclusion.) Therefore, in order to replicate the tax treatment of a cash sale, the

39. In a cash sale, this gain is generally thought of as the seller's gain. In the case of assumed liabilities that have not yet been taken into account by the seller, however, the seller's gain will be offset (absent character differences) by the allowance of a deduction for the amount of the liability.

expected value of a liability must be reasonably ascertainable. Although, as explored more fully below, there may be many circumstances in which such a determination of the expected value is difficult, the alternatives which require such a determination are worth explicating if only to make clearer the nature of the errors introduced when such a determination is not made.

A. Professor Halperin's Preferred Method

Under the analysis outlined by Professor Halperin, the assumption of contingent liabilities in connection with asset sales should be accounted for by allowing the buyer basis, as of the time of the purchase, to the extent of the expected value of the liabilities assumed. (This same amount would have been paid in cash by the buyer had the liabilities not been assumed, and must be included in the basis to be allocated to the assets purchased in order to assure that the appropriate cost recovery is allowed.) If the liability is resolved for an amount equal (in present value terms) to this expected value, then no further adjustments need to be made.

If, however, the liability is resolved in a way that is unfavorable to the buyer, the buyer should be allowed an additional deduction. This deduction, however, should be allowed only to the extent that the resolution value exceeds the expected value, adjusted for the passage of time. On the other hand, if the resolution value is less than the expected value, adjusted for the passage of time, the buyer should recognize income as of the time that the contingencies are resolved.

		Year 1	Year 2	Year 3	Year 4	Present Value of cost recovery as of Year 1
Payment as expected: 106 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
Payment more than expected: 200 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
	Loss allowed $200-106=94$		94			<u>88.6</u> 183.2
Payment less than expected: 50 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
	Gain recognized $50-106=56$		56			<u>52.8</u> 41.8

Halperin's Preferred Method: Immediate Basis Inclusion with Limited Adjustment for Resolution

This method works reasonably well when it is anticipated that there will be a definite time at which the contingency will be resolved. To the extent that there is no such time, and therefore possible resolution gains are not taken into account, the buyer will have been allowed cost recovery on a price that she has never paid. It also works effectively when there is a high level of confidence about the ability to identify the payments associated with assumed liabilities. If payments are not so identified, excess deductions may be claimed, as payments are misclassified as current costs as they are paid.

To avoid this result, Professor Halperin suggests relaxing the standards for connecting payments with particular assumed contingent liabilities. A buyer would be allowed to deduct and add to basis any payment that would be associated with such assumed liabilities, but "on the dates projected for the expected payments [as of the time of the sale] the buyer could be required to forgo deductions equal to the anticipated payments, or to include an equivalent amount in income, regardless of whether actual events are consistent with the estimate."⁴⁰

B. First Alternative Method: Accounting for Price Adjustments as Amounts are Paid

The problem associated with cost recovery for costs never incurred could also be solved by postponing the allowance of cost recovery under Professor Halperin's preferred alternative method, that is, by deferring the allowance of cost recovery until payments are actually allowed on the liability. Cost recovery would be allowed for the amounts actually paid, when paid, to the extent of the expected value of the liability adjusted for the passage of time.⁴¹ A new recovery period would begin with each payment on the contingent liability. To the extent that amounts are paid in excess of this expected value, adjusted for the passage of time, deductions would be allowed.

40. Halperin, Assumption, *supra* note 1, at 694.

41. *Id.* at 697-700.

		Year 1	Year 2	Year 3	Year 4	Year 5	Present Value as of Year 0
Payment as expected: 106 in year 2	Cost recovery allowed		35.32	47.11	15.69	7.84	94.6
Payment more than expected: 200 in year 2	Cost recovery allowed		35.32	47.11	15.69	7.84	94.6
	loss allowed 200-106=94		94				<u>88.6</u> 183.2
Payment less than expected: 50 in year 2	Cost recovery allowed (<i>on amount actual- ly paid, and amount taken into income</i>)		35.32	47.11	15.69	7.84	94.6
	gain recognized 50-106=56		56				<u>52.8</u> 41.8

Halperin's Preferred Alternative Method: Deferred Basis Inclusion with Adjustment for Resolution

Evaluating the results of this method in the event that the liability is resolved in the buyer's favor is more problematic. If the liability is resolved in the buyer's favor, the buyer has in effect enjoyed a bargain purchase. It is unclear whether, in terms of realization, this bargain element should be taken into account by the buyer. In order to replicate the results of a cash sale, however, this bargain element must be taken into account. If the bargain element is taken into account, cost recovery on this amount should be allowed, a complicating detail which Professor Halperin overlooks. In sum, the alternative preferred method cannot mimic the tax results of a cash sale unless, when the contingency is resolved in the buyer's favor, two abstract adjustments are made, one including the favorable resolution in income, and the other allowing cost recovery on this newly included amount.⁴²

42. The current treatment allowed in the case of sales to which § 338 (outlined in Temp. Regs. § 1.338(b)-3) applies, resembles this treatment; but because (1) it does not clearly allow for an increment above the original price resulting from the passage of time, and (2) it does not allow a deduction for resolutions more burdensome than anticipated, or for gain for resolutions less burdensome, it will produce results equivalent to a cash sale only when the burden of the liability is correctly predicted.

C. Professor Halperin's Second Alternative Method

Both the preferred method and the first alternative approach require relatively complex adjustments throughout the period during which the contingent liability remains outstanding. The preferred method requires adjustments only at the time the contingency is resolved. This method will produce no error in the total definition of the tax base when the contingency is resolved against the buyer, for the buyer will be allowed a deduction that (assuming appropriate discount rates are used) reflects the economic burden the liability ultimately borne. It will, however, produce a relatively large error when the contingency is resolved in favor of the buyer, since the buyer has been given basis credit for an amount that has not and may never be paid. Only if some arbitrary resolution mechanism is introduced will this basis credit ever be undone. The first alternative method requires the use of abstract cost recovery, based on the actual characteristics of the assets purchased in the sale, but with allowances unrelated to the presence of these assets as of the time cost recovery begins. If the basis for which this abstract cost recovery is allowed would have been allowed other than through cost recovery allowances (for instance, because the assets have been resold) additional abstract adjustments would be necessary.

These complex adjustments could be avoided by using a second alternative method.⁴³ This method would in effect assume in advance that the contingency is resolved without the buyer making any payment at all, but nevertheless allow the buyer cost recovery for the fair market value of the assets acquired. Under this method, the buyer takes *into income* the expected value of the assumed liability at the time of the acquisition and is allowed a deduction for all amounts subsequently paid.

43. This method is suggested by Professor Halperin as a variant of his preferred method. Halperin, Assumption, *supra* note 1, at 696-97.

		Year 1	Year 2	Year 3	Year 4	Present Value as of Year 0
Payment as expected: 106 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
	Upfront income inclusion	100				100
	Deduction for payment		106			<u>100</u> 94.6
Payment more than expected: 200 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
	Upfront income inclusion	100				100
	Deduction for payment		200			<u>188.6</u> 183.2
Payment less than expected: 50 in year 2	Cost recovery allowed	33.33	44.45	14.81	7.4	94.6
	Upfront income inclusion	100				100
	Deduction		50			<u>47.1</u> 41.7

Second Alternative Method: Buyer's Income Inclusion and Deduction of all Other Amounts

This second alternative method has several distinct advantages: first, it comports with a recharacterization of the liability assumption in which the seller pays the buyer cash for the liability assumption (giving the seller sale treatment and the buyer income) and then the buyer uses this cash to purchase assets from the seller (giving the seller an amount realized and the buyer basis in the assets so acquired). Because this method merely reflects a recharacterization of the sale transaction, it could be adopted without enabling legislation. Finally, as Professor Halperin acknowledges, this method minimizes the distortion involved in choosing discount rates.

VIII. WHAT IF THE EXPECTED VALUE CANNOT BE ACCURATELY DETERMINED?

Although assumed liabilities may be identifiable, the fact that they are identifiable does not mean that they are quantifiable. For instance, a seasoned buyer of smaller mining operations may be able to predict, in the aggregate, the upside and downside risks of its purchases. A certain number of properties will have more remaining reserves than predicted; a certain number

will have less. Similarly, a certain number will have more environmental problems than predicted, but others will have less. The agreement between a buyer and a seller regarding the sum of these possibilities does not indicate that they would have agreed to anything about the burdens or benefits associated with any particular risk involved in the purchase. Indeed, the buyer may be taking into account the overall risks involved in a series of purchases separately negotiated with a series of sellers. Assuming the buyer assigns a particular value to a particular risk in one of a series of asset purchases may be entirely unrealistic. The buyer may instead, simply by reviewing the way in which each business has been conducted in the past and using his overall knowledge of the industry, make aggregate assumptions about the liabilities he will find that he has assumed.

Two approaches to accounting for contingent liabilities are available if one assumes that the expected value of these liabilities cannot be ascertained either as of the time of sale or in retrospect. The first would require capitalization of all amounts paid with respect to assumed contingent liabilities as if all amounts paid were in effect part of the purchase price for assets.⁴⁴ This approach clearly imposes a greater tax burden than would be required had cash been paid. But with the introduction of section 197 and the general availability of fifteen year amortization for all intangibles, the burden of this extra tax has been substantially reduced.⁴⁵

The other alternative would allow current deductions for all payments made with respect to assumed current liabilities.⁴⁶ As Professor Halperin's

44. Current law seems clearly to require this result, although it is ambiguous whether the capitalization should be as of the time of payment using a new recovery period, or as of the time of the sale, with or without an adjustment for the passage of time. Case law has simply required the capitalization of all amounts paid. See, e.g., *David R. Webb Co. v. Commissioner*, 77 T.C. 1134 (1981), *aff'd* 708 F.2d 1254 (7th Cir. 1983); *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), *rev'g per curiam*, 29 T.C. Memo. (CCH) 133, 39 T.C. Memo. (P-H) ¶ 70,040 (1970), *cert. denied*, 415 U.S. 948 (1974) and *reh'g denied*, 416 U.S. 952 (1974). The regulations under § 338 provide a variant on this approach, apparently allowing basis when the liability is fixed (rather than when paid).

Thus, current authority suggests directly tying all payments to assets acquired, an approach that clearly will overstate the value of assets acquired when contingencies are resolved unfavorably to the buyer.

45. Assuming a 6% after-tax interest rate, a payment technically entitled to an immediate deduction is reduced by 15-year amortization to a series of future deductions worth about 64% of the value of an immediate deduction. Without amortization under § 197, the denial of an immediate deduction would have produced basis only available on a later taxable sale of assets.

46. This treatment has been proposed, among other places, by the New York State Bar Association Tax Section. Richard L. Reinhold, Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions, 49 Tax Notes 883 (Nov. 19, 1990).

analysis reveals, this treatment would produce the same result as allowing a deduction at the time of the sale for the expected value of the liability. (It would also provide an automatic adjustment for the resolution value, to the extent that the amount actually deducted varied from this expected value.) To the extent that the contingent liability related to arrangements, like deferred compensation, that involve values that will be omitted from the tax base unless surrogate taxation is used, the overall transaction will be undertaxed under this alternative. The benefit to the taxpayer of accelerating the deduction as an offset to income for the amount paid on the liability would depend upon the cost recovery that would have been allowed on the assets acquired had the expected value been known and properly accounted for.⁴⁷ To the extent, however, that the contingent liability relates to arrangements in which surrogate taxation is not appropriate, the degree of undertaxation will be less. (There may be a lesser tax burden as a result of the sale of the assets than there would have been without the sale, as will generally be the case when losses recognized on assets as a result of the sale are greater than gains so recognized.)

From a practical standpoint a comparison of the alternatives for accounting for assumed contingent liabilities must take into account the effects of the likely errors involved in the implementation of these alternatives. Under all methods, there will be an advantage to understating, if not ignoring completely, the expected value of the contingent liability, at least if one assumes that payments that are not treated as payments on the expected value of the liability are entitled to current deduction. This advantage will always be the difference between the value of current deduction for the expected value of the liability, and the value of the cost recovery that would have been available had the expected value of the liability been assigned a proper cost recovery. Indeed, the understatement of a contingent liability and the ignoring of the fact of the liability assumption involve exactly the same potential error: avoiding the drag on deductions involved in proper capitalization and cost recovery.

IX. SHOULD THE ACCOUNTING FOR A CASH PURCHASE BE THE ONLY NORM FOR EVALUATING POSSIBLE ACCOUNTING TREATMENTS?

Professor Halperin's analysis began with the proposition that all transactions in which liabilities are assumed should receive the same tax

47. A current deduction with a present value of 1 has been allowed instead of cost recovery with a present value of .64 if the acquired assets were primarily intangibles for which 15-year amortization is available under § 197; about .44 if the acquired assets were primarily commercial real estate; of undeterminable value if the assets were primarily unimproved real estate for which cost recovery would be allowed only upon sale.

treatment as transactions in which only cash is given as consideration. This starting point assumes that it is possible to identify a cash price that represents the fair market value of the assets in question, without regard for the tax treatment anticipated in connection with the future use of the assets. This may be an ill-conceived notion. The price of virtually any asset will reflect the tax treatment of the ongoing business anticipated by the buyer. Although it may be possible to assign to any individual asset a cash price and a technically correct tax accounting treatment of that cost, it seems unlikely that this will be possible (and certainly not worthwhile) for sales of business assets. Each such sale will have associated with it commitments to make future payments—at both favorable and unfavorable prices. Each such commitment will produce a deviation from the cash price for the individual assets, and will increase the likelihood that no technically correct tax accounting will be possible. To the extent that the most likely tax accounting will be favorable to the buyer, the buyer may be willing to pay more than otherwise; to the extent that the most likely tax accounting will be unfavorable, the buyer will be willing to pay less than otherwise.

Reproducing the tax treatment of all cash sales therefore may not be the only criterion for evaluating the accounting treatment afforded assumed contingent liabilities. Indeed, to the extent that establishing the technically correct treatment in every case is futile, the possible accounting treatments should be evaluated primarily according to whether the consequences of getting the accounting wrong are tolerable.

At least two factors determine whether tax accounting errors will be tolerable. The first is the degree to which taxpayers can take advantage of these errors, and the second is the range of disparity in the ability of taxpayers to take advantage of these errors. If a taxpayer truly has no control over its ability to take advantage of a tax accounting error, then (although the error may create a windfall) the consequences of the error are likely to be tolerable. Similarly, virtually any tax accounting error would be tolerable if every taxpayer could be assumed to be equally able to take advantage of (or to be burdened by) the accounting error, so long as a limit exists that prevents arbitraging to such an extent that no tax base remained.

Most tax accounting errors, however, fall somewhere in the middle. Some taxpayers are better able to take advantage of favorable tax accounting errors than others, but not to so great an extent that the benefit of the error is entirely capitalized in the asset involved. Some taxpayers are disadvantaged to a sufficient degree that the activities in which they are involved bear a heavier tax, and perhaps attract less capital than they otherwise would.

Choosing among technically imperfect tax accounting rules requires predicting which effects are most likely, and which of these effects are most tolerable. In choosing the tax treatment of assumed contingent liabilities, predictions need to be made about the taxpayers most likely to be affected.

Under all of the technically correct methods, taxpayers can obtain real tax advantages by characterizing portions of the purchase price as contingent liabilities, and then underestimating the expected value of that liability.⁴⁸ Given this reality, it may be more appropriate to simply adopt an accounting treatment that is less favorable than cash to avoid the possibility for abuse of a more favorable method.

On the other hand, some industries may be able to avoid assumptions of contingent liabilities in connection with asset transfers because insurance is more readily available for the risks inherent in that industry.⁴⁹ If so, there may be identifiable classes of taxpayers that are put at a disadvantage because they may be unable to avoid the consequences of assumed contingent liabilities and the onerous accounting methods that they require. Nevertheless, we might be willing to tolerate the error if the effects are felt uniformly throughout an industry and there is little possibility that asset transfers within that industry will be burdened more than asset transfers in other industries. If a particular industry is intolerably affected, and especially if a substantial portion of the liabilities faced by the industry reflect destroyed values rather than merely transferred values, then selective use of more favorable accounting treatments may be appropriate.

X. CONCLUSION

Professor Halperin's analysis of the appropriate tax accounting for contingent liabilities is correct to the extent that all contingent liabilities represent obligations to pay for values that have not yet been included in the tax base.

His conclusions are based on the assumption that all contingent liabilities should be treated similarly for the purposes of tax accounting, and that none should be given as favorable tax accounting treatment as fixed liabilities. It is possible, however, that at least some contingent liabilities are in effect borrowings of after-tax values, and thus have more in common with traditional bank borrowings than with deferred compensation.

Thus, to the extent that contingent liabilities represent either (1) obligations to repay for values that were previously included in the tax base but for which an income offset has been deferred or (2) obligations to repay

48. An advantage could also be gained from underestimating the discount rate used to compare actual payments with the estimate of expected value. With such an underestimate, fewer favorable resolutions would be identified as such and more resolutions would be assumed to be unfavorable.

49. If insurance is available, the overall taxation of the asset transfer will be less than that urged by Professor Halperin if, and to the extent that, tax accounting for insurance effectively allows an immediate deduction for a reserve against the liability.

for values that are not ordinarily included in the tax base, Professor Halperin's proposed treatment may lead to overtaxation. (The degree of overtaxation involved will depend upon clarification of the as-yet undeveloped norm for realization of gains and losses with respect to liabilities transferred in connection with sales of assets.)

Although it may be possible for some taxpayers to establish that the liabilities related to their businesses warrant more favorable tax treatment than that proposed by Professor Halperin, this possibility alone is not enough to warrant more favorable treatment across the board than that advocated by Professor Halperin. Indeed, good arguments can be made that the appropriate treatment of assumed contingent liabilities should be more, rather than less, onerous than the most technically correct method, especially if all taxpayers are equally able to arrange the terms of the sale of assets in such a manner so as to avoid this more onerous treatment.