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Assumption of Contingent Liabilities on Sale of a Business

Daniel Halperin[*]

* Professor of Law, Georgetown University Law Center. I thank Professor Charlotte Crane and Michael Schler for their comments on an earlier draft of this article. I am also indebted to my colleagues Professors Stephen Cohen and Martin D. Ginsburg and to the participants at a Seminar on Current Research in Taxation sponsored by the Harvard Law School Fund for Tax and Fiscal Research, particularly Professor Alvin C. Warren, for their suggestions. I further thank my research assistants, particularly Steven Clemens and Jessica Chun, for their help.

I. INTRODUCTION

This article discusses the federal income tax consequences of a buyer's assumption of contingent liabilities in a taxable sale of the assets of a trade or business.[1] Although judicial precedent remains scarce, several articles written over the past few years have considered this issue.[2] Nevertheless, the matter remains unsettled both as to the theoretically correct result and, perhaps, more importantly, as to what is required to achieve a workable solution.

Since the Treasury apparently considers the treatment of contingent liabilities to be ripe for a regulation project,[3] my hope here is to clarify the issues and to present the options in a comprehensive and orderly manner so as to facilitate a decision. Although I do not describe current law in detail, I indicate where the possible approaches might differ from existing precedent and, therefore, to what extent it might be necessary to seek legislation.[4] A solution is made more difficult, in some circumstances, by the reintroduction of a substantial difference between the rates applicable to ordinary income and capital gains.

An appreciation of the issue's ramifications requires a sophisticated understanding of the impact of what has been referred to as the "time value

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1. The term "taxable sale" includes a deemed transfer of assets following a sale of stock under a § 338 election. Under present law, taxpayers rarely make § 338 elections, and C corporations usually prefer tax-free reorganizations or stock sales to asset sales. See Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions, and Buyouts § 107.2, at 33 (1995). Thus, the issues discussed here may arise mostly in connection with asset sales by sole proprietorships, partnerships, and S corporations.

2. See, e.g., Kevin M. Keyes, The Treatment of Liabilities in Taxable Asset Acquisitions, 2 N.Y.U. Inst. on Fed. Tax'n ch. 21 (1992); Charlotte Crane, Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless? 48 Tax Notes 225 (July 9, 1990); Committee on Alternative Minimum Tax, N.Y. State Bar Ass'n, Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions, 49 Tax Notes 883 (Nov. 19, 1990) [hereinafter NYSBA]; Michael L. Schler, Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More, 43 Tax L. Rev. 605 (1988); Robert R. Wootton, Mrs. Logan's Ghost: The Open Transaction Doctrine Today, 71 Taxes 725 (1993); Alfred D. Youngwood, The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions, 44 Tax Law. 765 (1991).

3. See Robert J. Wells, Officials Discuss Corporate Inversions Guidance, 67 Tax Notes 1419 (June 12, 1995).

4. Contrast the conflicting views of Alfred D. Youngwood and the NYSBA as to their similar proposals. Youngwood suggests legislation is necessary, while the NYSBA declares it is not. NYSBA, supra note 2, at 885; Youngwood, supra note 2, at 782. The NYSBA, however, would modify its proposal in those few situations where there is clear judicial precedent to the contrary. NYSBA, supra note 2, at 884.

of money,"[5] including the role of "matching" of income and deductions (to compensate for an error in the treatment of one of the parties) and the fact that changing the timing of income inclusions or deductions need not affect the value of the item if interest and tax rates do not change.[6]

I hope to show that the approach of ignoring contingent liabilities, which is advanced by some and is described in Part V, is more generous than its supporters might appreciate and that the difficulties and potential for abuse inherent in taking account of contingent liabilities, while significant, are not as great as some might fear. These conclusions derive from my belief that the present value of contingent liabilities is appropriately measured by discounting the expected payments at an after-tax rate of interest. A main goal of this article is to convince readers that this is correct.

II. OUTLINE OF ISSUES

If a buyer assumes liabilities on the acquisition of a business, the amounts of cash and other consideration is reduced accordingly. Instead of the assumption, the buyer could pay more cash, and the seller could use a portion of the cash to pay its debts. The buyer could raise the extra cash by borrowing to replace the liabilities paid by the seller. An assumption should produce tax results that are reasonably consistent with those of an all-cash purchase.

It is helpful to divide liabilities into two categories. The first is where the seller obtains a tax attribute upon incurring the liability. In most situations, a taxpayer borrowing funds or incurring a liability either is allowed a deduction or an increase in the basis for its assets or obtains cash which can be used to pay a deductible expense or purchase an asset. Payment of the liability has no tax consequences, aside from the deduction for interest.[7] Borrowing from a bank is used in this article as an example of this type of liability.

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5. See generally Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506 (1986).

6. For a general description of this recurring phenomenon, see Alvin C. Warren, Jr., The Timing of Taxes, 39 Nat'l Tax J. 499 (1986).

7. The treatment of these liabilities is straight forward, except where the face amount of the liability (more accurately, its adjusted issue price) differs from its fair market value. This occurs if the applicable interest rate has changed since the debt arose. See generally Keyes, supra note 2, § 21.03[2][c]; Alvin H. Shrago, The Uncertain Tax Treatment of Liabilities in Corporate Acquisitions, 2 N.Y.U. Inst. on Fed. Tax'n ch. 19 (1994); Schler, supra note 2, at 648-51. A question may also arise when there is an assumption of nonrecourse liabilities which, when added to the other consideration paid, exceed the value of the assets transferred. Discussion of these issues is generally beyond the scope of this article, but there is a brief synopsis in Appendix I.

Second, a seller may have a liability that has accrued economically, in the sense that the value of the business is diminished, without obtaining either a deduction or an addition to basis.[8] This may occur because the liability is too contingent to be recognized for tax purposes,[9] because of matching rules that require payment before a deduction may be taken,[10] because of the economic performance rules,[11] or because the seller is on the cash basis. In this second situation, a future event, perhaps payment, may, in the absence of the buyer's assumption, have resulted in a deduction or basis addition for the seller. In this article, a deferred compensation arrangement is used to illustrate a liability of this kind.

Deductions are sometimes deferred in order to facilitate more accurate measurement. For example, where there is a long delay until payment, it may be desirable to delay the deduction to avoid the problem of "discounting."[12] As discussed below, deferral is also often intended to over-tax the payor to compensate for a deferral of the intended payee's recognition of income. In the latter situation, if the payor's sale of the business has the effect of causing its income to be accurately measured, the seller is no longer over taxed, and it may be appropriate to transfer this burden (the equivalence of a delayed deduction) to the purchaser.

Ideally, in order to achieve consistency with an all-cash transaction, the amount of the liabilities assumed in a taxable sale of a business should, in all circumstances, be added at the time of the sale to both the amount realized by the seller and the purchase price. Payment of the liability should have no tax consequences. With respect to the first category of liabilities (the bank loan), but not the second (the deferred compensation arrangement), a buyer should be entitled to a deduction for interest accrued after the sale. In the second situation, if the seller, in the absence of the sale, would have been entitled to a deduction upon payment of the liability (or another future event), it should be granted a deduction at the time of the sale. These conclusions are described and discussed in Part IV.

Some have recommended that for practical reasons, an assumed *contingent* liability should not be included in either the selling price or the

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8. See Keyes, supra note 2, § 21.02[1].

9. Under the all events test, contingent liabilities are not deductible because all of the events that determine the fact of liability have not occurred. Regs. § 1.461-1(a)(2)(ii).

10. For example, under § 404(a)(5), deferred compensation that is not part of a qualified plan cannot be deducted until it is included in the employee's gross income—generally when paid. See also IRC § 267(a)(2) (denying a deduction for liability to a related party until the "amount is includible in the gross income of the person to whom the payment is made").

11. Under § 461(h), enacted in 1984, no deduction may be taken for an accrued liability before "economic performance," often payment, has occurred.

12. See Ford Motor Co. v. Commissioner, 102 T.C. 87, 100-01 (1994).

buyer's basis for the assets and that the buyer should instead step into the seller's shoes, being allowed a deduction at the time and in the amount that the seller would have been entitled to had the sale not taken place. This proposal is discussed in Part V. The main thrust of this article is to consider the appropriateness of this proposal as compared to treating contingent and fixed liabilities in the same way. My conclusions are summarized in Part VI.

I begin in Part III with a discussion of the appropriate treatment of *fixed* liabilities in the second category.

III. FIXED LIABILITIES-DEFERRED COMPENSATION

A. *Creation of Liability*

Initially, it is assumed that the parties can always earn 10% interest and are always subject to a 40% tax rate. Complexities caused by differences in or changes to the interest rate or the tax rate are introduced at a later point.

Assume Edwards (*E*), an employee of Standard Corp. (*S*), is entitled to salary of $100 on the last day of year 1. If *E* is paid currently and deposits her after-tax earnings with Bank *B*, she will, if tax on the interest is paid from the account, have a balance of $63.60 on the last day of year 2.

Wages	$100.00
Tax at 40%	40.00
Net wages	60.00
Interest at 10%	6.00
Tax at 40%	2.40
Net interest	3.60
Balance	$ 63.60

Suppose *S* and *E* agree to defer her salary for one year, until the last day of year 2. If *E* uses the cash method (as is almost invariably the case for employees), she is taxed on the salary, and *S* can deduct it, only when payment is made and received.[13] If *S* is willing to pay the same rate of interest as Bank *B*, *E* will have $66 after tax.

Wages year 1	$100.00
Plus 10% interest	10.00
Deferred wages	110.00
Tax at 40%	44.00
Net	$ 66.00

13. For *E*'s recognition of income, see Reg. § 1.451-1(a); Rev. Rul. 60-31, 1960-1 C.B. 174, modified, Rev. Rul. 64-279, 1964-2 C.B. 121 and Rev. Rul. 70-435, 1970-2 C.B. 100. For S's deduction, see IRC § 404(a)(5). Employees of tax-exempt organizations and governments might not be able to achieve deferral. IRC § 457.

However, does the deferral of *S*'s deduction until payment affect the interest it might be willing to pay?

If *S* pays $100 to *E* immediately, it can deduct the payment for a tax savings of $40. If it invests this amount for one year, at its 6% after-tax return, this amount accumulates to $42.40 at the end of the year, as is shown in Column I of Table I. Alternatively, if *S* sets aside $100 and earns 6% after-tax, it will have $106 after one year, and on payment and deduction of this amount, the tax savings will be $42.40, as shown in Column II. This suggests that *S* should be indifferent between immediate and deferred payment only if, in the deferral case, its liability increases by the after-tax rate of return (6%), rather than the 10% pretax rate. A year 2 payment of $106 also places *E* in the same position she would have had if she were paid in year 1.

Deferred wages	$106.00
Tax at 40%	42.40
Net	$ 63.60

Thus, if the parties desire to maintain their economic positions, a deferred obligation should, in this context, bear interest at an after-tax rate.

As I have argued elsewhere, this occurs because the deferral of the deduction is equivalent to an immediate deduction for the compensation and the denial of any deduction for the interest.[14] It may appear that the $106 deduction for the deferred compensation effectively includes $6 of deduction for interest. However, $106 in year 2 is equivalent in value to $100 in year 1 because the 6% after-tax interest rate merely compensates for the delay in the deduction. Thus, *S* can be said to fully deduct the compensation, as if there were no delay, but be denied a deduction for interest.

Compare Column III where, even though payment is deferred, *S* is granted an immediate tax deduction of $100, saving $40. If no further deduction is allowed for interest, Column III shows that despite the immediate deduction, *S* continues to be indifferent between an immediate distribution of $100 and a deferred distribution only if the liability increases by the 6% after-tax rate of return.[15]

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14. See Halperin, supra note 5, at 511, 522-23. This observation is the converse of the familiar point that an acceleration of a deduction is equivalent to a deduction at the appropriate time, coupled with a tax exemption for the income generated by the deducted item from the time of the accelerated deduction until the appropriate time for deduction.

15. For a detailed discussion of why the tax law may choose to defer the deduction in such a situation, see Halperin, supra note 5, at 531-34. For one thing, if the agreement merely calls for a payment of a particular amount at a future time, determining the present value of that liability requires a determination of the appropriate interest rate.

Table I

	I Year 1 Payment	II Year 2 Payment Deferred Deduction	III Year 2 Payment Immediate Deduction
a. Transfer to *E* or set aside	100	100	100
b. Tax Benefit from deduction (40% of a)	40		40
c. Amount retained by *S*	40	100	140
d. Pretax earnings (10% of c)	4	10	14
e. Tax (40% of d)	1.60	4	5.60
f. Net earnings (d-e)	2.40	6	8.40
g. Available to *S* (c+f)	42.40	106	148.40
h. Distribution to *E*	--	106	106-
i. Tax Benefit from year 2 deduction	No payment	42.40	No Deduction
j. Retained by *S* (g-h+i)	42.40	42.40	42.40

In sum, in the case of deferred compensation, the employer's deduction is deferred to compensate for (or match) the corresponding deferral of income by the employee. Because of the deferral, the amount of the deferred payment is likely less than it would have been if the employer's tax, like the Bank's, were accurately computed—that is, if in addition to an immediate deduction of $100 for compensation, *S* were allowed to deduct the interest accrued on its obligation. If *S* cannot deduct interest, it can be expected to compensate by accruing interest on the obligation to *E* at an after-tax rate. If *E* only earns interest at an after-tax rate, this offsets the tax advantage achieved by the employee through deferral. Since, deferral of taxation is equivalent to tax exemption of investment income, if *E* earns an after-tax rate of return, she is in the same position as if she earned a pretax rate and investment income were taxable.

Nevertheless, many deferred compensation arrangements appear to provide pretax rates of interest to employees.[16] This might occur because the employer is not currently subject to tax (e.g. as a result of a net operating loss deduction) or because the employer earns a much higher pretax rate of return than the employee. In the latter case, what appears to be a pretax rate of return from the employee's perspective accurately reflects the employer's after-tax earnings. This is discussed further below when I consider differences in interest and tax rates either over time or as between the parties.

If the parties are subject to the same rates of interest and tax, an employer who credits interest at 10%, in lieu of 6%, is assuming a larger burden than if it paid $100 in current compensation. If, in line h in Column II of Table I, *S* pays $110 to *E* and receives a tax benefit of $44, *S*'s retention, at the end of one year, is $40 ($106-$110+$44), as compared to $42.40. The reduction of $2.40 is the after-tax cost of its additional payment of $4. Thus, in these circumstances, *S* effectively continues to credit interest at 6% and has increased *E*'s compensation to $103.77.[17] Possibly the employer does not grasp the cost of providing a pretax return. More likely, it has a reason to increase compensation if the employee accepts deferral.[18]

B. *Transfer of the Liability*

Suppose on the last day of year 1, *S*, in connection with a sale of its business or otherwise, wishes to pay Production Corp. (*P*) to assume its obligation to pay *E* $106 on the last day of year 2. How much would *S* have to pay?

The answer to this question would be reasonably clear if the obligation were an ordinary borrowing. Assume *S*, on the last day of year 1, borrows $96.36 from Bank *B*, agreeing to repay $106, including interest at 10%, in one year. If *S* pays *P* $96.36 to assume the debt to *B*, *P* can, by investing this amount at a pretax return of 10%, accumulate the $106 needed to pay *B*, provided that the interest paid to the bank is deductible, offsetting the interest income.

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16. Deborah Rankin, The Case for Deferred Compensation, N.Y. Times, Jan. 25, 1987, § 3, at 11.

17. If $103.77 were paid as current compensation, the tax savings would be $41.51, which, if invested to earn 6% after-tax, would accumulate to $44 at the end of one year. Put another way, $103.77 is the present value of $110 in one year at 6%.

18. See Daniel I. Halperin, Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue? 49 Tax L. Rev. 1, 8-10 (1993).

Received from *S*	$ 96.36	Taxable Income	
Interest income	9.64	Interest income	$9.64
Total	$106.00[19]	Interest expense	9.64
		Taxable income	-0-

Returning to the original case, if *P* could similarly deduct the interest on its payment to *E*, it would also agree to assume *S*'s obligation to *E* for a payment of $96.36. But recall that *E*, in return for $106 of deferred compensation, agreed to defer wages of $100. *S* would have a windfall if it could relieve itself of this obligation by paying *P* only $96.36, at least if this payment is deductible as $100 of current wages would be. To put *S* in the same position as if it had paid current compensation, it would have to make a $100 deductible payment to *P*. However, *P* would have a windfall if it would not taxable be on the receipt of $100 from *S* and could deduct the interest owed to *E*.

Amount received	$100.00	Interest income	$10.00
Interest at 10%	10.00	Interest expense	6.00
Total available	$110.00	Taxable income	$ 4.00
Payment to *E*	$106.00	Tax at 40%	$ 1.60
Taxes	1.60		
Net to *P*	$ 2.40		

The key to preventing any advantage from the transfer of the liability lies in the fact that the postponing of *S*'s deduction until payment is equivalent to an immediate deduction of $100 (which *S* gets if it can deduct the payment to *P*), with no additional deduction for interest. Thus, in the simple world of uniform interest and tax rates, *S* can be allowed a deduction for the $100 payment to *P* (and *P* need not be taxable), as long as *P* is allowed no deduction for the payment of the additional $6 to *E*. It is, as noted above, the denial of the interest deduction, not the deferral, that is important.

Payment from *S*	$100.00	Taxable income	$10.00
Interest 10%	10.00	Interest deduction	-0-
Amount available	110.00	Net taxable	$10.00
Payment to *E*	106.00	Tax	$ 4.00
Tax	4.00		
Total Payments	$110.00		

19. Arguably, *P* is taxable on the money received from S. If so, *P* would accept $96.36 as payment for its assumption of the liability only if it could claim an immediate offsetting deduction for its obligation to Bank *B* and an additional deduction of $9.64 to reflect the increase in its obligation after one year.

Even if the interest deduction is denied, *S* might reap a net tax savings by transferring the liability to a tax-exempt *P* or to a *P* subject to a lower marginal rate of tax. Denying *P* an interest deduction to compensate for the deferral of income by *E* is to no avail if *P* is tax-exempt. Therefore, *S* should generally not be allowed to accelerate its deduction by paying *P* to assume its liability.[20] However, as discussed below, in the context of a sale of a business, allowing *S* a deduction should be acceptable.

C. *Sale of the Business*

1. *The Facts.*—Consider the following example, which again assumes the parties always earn 10% before tax and are always subject to tax at 40%. Production Corp. (*P*) plans to acquire the assets of Standard Corp. (*S*) on the last day of year 1. The assets have a basis of $200 and are worth $500. *S* has two liabilities:

a. A $100 loan from Bank *B*, which is due, together with 10% interest, in one year (the last day of year 2).[21]
b. Deferred compensation of $106 due to Edwards (*E*) on the last day of year 2.

If *S* retains the liabilities to *B* and *E*, *P* will pay $500 for the business and *S* will pay *B* $110 and *E* $106 in one year. If *P* assumes the liabilities, *S* should receive only $300. The difference of $200 is, as described below, the present value of the liabilities—the amount *S* or *P* would have to expend to extinguish the debts at the time of the sale.

Whether it transfers $500 to *S* or reduces the payment to $300 to reflect the assumption of the liabilities, *P* effectively pays $500 for the assets. This should be its basis. Similarly, in either event, *S* receives $500 (perhaps in part through liability relief), and its gain should be $300 ($500, less basis of $200).

2. *Treatment of S.*—As just stated, if *S* sells for cash, part of which is used to pay its liabilities, it will have a $300 gain. Nothing should change if *P* holds back part of the cash and assumes the debt. Also, in both cases, *S*

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20. If *S* can shift assets to a tax-exempt entity for more than one year, merely delaying *S*'s deduction until *P* pays does not eliminate the advantage of avoiding tax on investment income. The investment income must be imputed to *S* despite the claimed transfer.

21. To make the example easier to follow, I have chosen here to hold the present value of the two obligations equal, at $100, with different amounts due in one year. In the previous section, to make the point, it was helpful for the amounts due in one year to be equal, which led to a difference in present value.

bears the economic burden of the payment to *E*, for which it has not yet obtained a deduction. Either it receives $500 and pays $106 to *E* in year 2, or it suffers an equivalent $100 reduction in the purchase price.[22] It should get a deduction that reflects its burden.

If *S* retains the liability to *E*, there is no problem. It merely deducts $106 when it pays, just as it would if the business had not been sold.

If *P* assumes the liability, *S* effectively pays $100 at the time of sale because the liability reduces the cash received for the business. *S* should get a deduction for this expenditure (or an addition to basis if the salary is capital rather than an ordinary business expense). While this accelerates the deduction as compared to the situation where the business is not transferred or *S* retains the obligation, the present value of the deduction is unchanged. A deduction of $100 at the time of the sale is mathematically and economically equivalent to a deduction of $106 one year later.[23] As shown in the first column of Table I, the $100 deduction produces a tax savings of $40, which if invested for one year at 10%, will accumulate to $42.40 after tax, the same amount that would be derived from a tax deduction of $106 for year 2.

In the case of an expressly-assumed liability, the regulations, in accord with much of the case law,[24] allow a seller this deduction in some circumstances.[25] The regulations provide that if a deduction would have been allowed but for the economic performance requirement, economic performance occurs as the seller takes account of the amount realized. Unfortunately, because sections 404(a)(5) and 267 require inclusion of income by the payee as a condition for a deduction, when either of these sections applies, the IRS may not be able to allow a deduction at the time of the sale without a change in the law.[26] In addition, the economic performance regulations do not deal with contingent liabilities.[27]

3. *Treatment of P.*—If the assets are worth $500, *P* should pay $300 in cash if it assumes the liabilities to *B* and *E*. The liability assumption

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22. If *S* receives $500, it should put $100 aside in order to meet its obligation to *E*, leaving it in the same position as if it received only $400. If *S* earns 10% interest and pays tax at a 40% rate, $106 will be accumulated at the end of one year.

23. See generally Staff of Joint Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 261 (1984) [hereinafter 1984 Bluebook]; Halperin, supra note 5, at 521-23, 531-34. Compare IRC § 468A.

24. Keyes, supra note 2, §§ 21.03[1][a], 21.04[2][a][iii]; NYSBA, supra note 2, at 885-87 (discussion of support for this position); Youngwood, supra note 2, at 772.

25. Regs. § 1.461-4(d)(5), (g)(1)(ii)(C).

26. See Priv. Let. Rul. 8939002 (June 15, 1989); IRS Technical Advice Memorandums, 45 Tax Notes 189-90 (Oct. 9, 1989); Keyes, supra note 2, § 21.04[2][a][iii].

27. See Regs. § 1.461-4(j) ("Contingent liabilities. [Reserved]").

should be reflected in *P*'s basis for the assets, which should be $500.[28] Upon payment of the loan to *B*, *P* can deduct interest of $10. Should *P* get a $6 interest deduction when it pays $106 to *E*?

As current law appears to require,[29] the answer should be no. Because *S*' deduction for the deferred salary would, in the absence of a sale, have been delayed until payment, we have assumed that interest on the deferred amount effectively accrues at an after-tax rate of return (6%). Denial of a deduction for the interest element is consistent with this assumption. If *P* reduces the amount it pays for the business by $100 to reflect its assumption of the liability to *E*, sets aside $100, earns 10% on this amount, and is subject to tax at 40%, it will, without any further deduction, accumulate the $106 needed to pay *E*.[30] If *P* could deduct the $6, it could fund the payment by setting aside less than $100,[31] which results in a windfall. Thus, *P*'s payment to *E* should give rise to no further deduction even though *P* will pay $106, not $100.[32]

If the $6 is not deductible, the buyer's cash payment is reduced by $100 for each of the two liabilities, even though in one case *P*'s payment one year later is $110 and in the other it is $106. Both have the same present

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28. It has been suggested that the rules deferring *S*'s deduction until payment also require that the basis addition on account of the assumption be delayed until payment to *E*. See Webb v. Commissioner, 77 T.C. 1134, 1138-39 (1981), aff'd, 708 F.2d 1254, 1256 (7th Cir. 1983); F&D Rentals Inc. v. Commissioner, 44 T.C. 335, 349 (1965), aff'd, 365 F.2d 34, 41 (7th Cir. 1966), cert. denied, 385 U.S. 1004 (1967); Wootton, supra note 2, at 740. However, if S' deduction would have been delayed solely because of § 404(a)(5), it is arguable that since *P* is not claiming a deduction for compensation, this section should not apply. Also, as discussed below in the text at note 70, a delay in the deduction need not be harmful to taxpayers if the basis addition is increased, here to $106 ($506 in total).

29. Schler, supra note 2, at 671; Wootton, supra note 2, at 740.

30. It is assumed that *P* is not taxed on the effective receipt of $200 (by way of a purchase price reduction) for its agreement to assume *S*'s obligations to *B* and *E*. See Commissioner v. Oxford Paper Co. 194 F.2d 190 (2d Cir. 1952); Rev. Rul. 55-675, 1955-2 C.B. 567. As discussed below in note 63, if *P* is taxed on the $100 related to the obligation to *E*, it should be allowed an offsetting deduction for its payment of $106. In present value, these two amount are equivalent. See also supra note 19 as to the loan to Bank *B*.

31. If the deduction was denied to *S* solely because it is on the cash basis, the deferral of the deduction is not necessarily intended to compensate for a tax advantage to the payee, and conceivably the obligation bears an inherent pretax rate of return. Thus, a buyer's interest deduction need not be denied if the sole reason for the delay is that the seller is on the cash basis. Such a liability could be treated like the loan to Bank *B* as far as the buyer is concerned.

32. If the buyer is in a lower tax bracket than the seller, there is an advantage, despite the denial of the deduction, because the lower tax rate reduces the detriment from the effective denial of the interest deduction. However, if the liability assumption is part of a sale of a business, we probably should not worry about a difference in tax bracket. See Wootton, supra note 2, at 739; Regs. § 1.461-4(d)(5)(iii), preamble at 57 Fed. Reg. 12,411 (1992).

value ($100), despite the difference in the payments, because they bear different rates of interest. The obligation to *B* bears a 10% rate of interest because the interest of $10 paid to *B* will be deductible by *S* or *P*. Thus, if *P* holds back $100, earns $10 interest, and pays $110 to *B*, no tax will be due because the $10 of interest income will be offset by $10 of interest deduction, leaving the entire $110 available to pay the bank. In contrast, since the interest paid to *E* will not be deductible, *P* (like *S*) will pay *E* $106, not $110, because it must pay tax on the $10 it will earn on its investment. If *P*'s expected liability to *E* were $110 rather than $106, it would hold back $103.77, not $100.

D. *Differences in Tax and Interest Rates*

1. *Business Not Sold.*—The discussion so far has been based on the unrealistic assumption of uniform interest and tax rates that never change. In reality, the parties may face different interest or tax rates, and these rates may change over time.

If each party is taxed on its own economic income, the tax law need not concern itself with varying interest rates because whatever interest is earned or paid is taken into account in measuring income and taxed at the appropriate rate. But, in the situations discussed here, taxable income departs from economic income in two ways, and we need to consider whether this raises additional problems if interest or tax rates differ or change.

First, effectively, interest income is not taxed to one party (*E*) and to compensate, the other party (*S*) is denied an interest deduction. This results in the correct amount of tax only if the parties pay tax at the same rate. It protects the revenue only if the payor is subject to tax at a rate at least as high as the payee. Conversely, the transaction is over taxed if the payor is taxed at a higher rate. While the parties can avoid this situation, it is a cause for concern if it leads them to forego economically sensible transactions for which there is no easily available alternative. Thus, this substitute or surrogate taxation of the employer in order to collect the employee's tax should be avoided unless there is no alternative.[33]

Secondly, the tax rules achieve the impact on interest through the indirect means of deferral of deduction and income inclusion. The example in Table I shows that if tax and interest rates are uniform and do not change, the deferral is equivalent to accounting currently for compensation and ignoring interest. This is true because the amount taken into account in the year of payment is equivalent in present value, at a uniform, unchanging interest rate, to the original compensation. Thus, taxing and deducting the deferred amount is equivalent to taxing and deducting the compensation when

33. See Halperin, supra note 5, at 544-50 (suggesting an alternative).

earned. What remains to be considered is the extent to which this remains true when the assumptions of uniformity and permanence are relaxed.

The compensation is taxed and deducted at the tax rate prevailing at the time of deduction and inclusion, rather than the rate when it was earned.[34] Assume first that overall tax rates do not change, but the employer's or employee's marginal rate is nevertheless different because individual circumstances have changed. For an employee whose income drops significantly after retirement, this might be viewed as a form of lifetime income averaging, mitigating the impact of progressive rates. For the employer, something similar to averaging, the extension of the carryover period for net operating losses, may sometimes be said to occur. Assume the employer has a net operating loss deduction for the year in which the compensation is earned and, but for the deduction for the deferred compensation, would have been taxed at a higher tax for the year of payment. In this case, the result of the deferred deduction is the same as if the deduction had been allowed in the earlier year and carried forward. It is not obvious that these results are inappropriate.

If tax rates increase or decrease overall, matching may play a role. For example, concern over avoidance of high wartime rates through deferral of compensation may be mitigated by the fact that the employer must defer its deduction.

If interest rates vary, either from party to party or over time, a party's after-tax rate of return may differ from the rate inherent in the arrangement. This could result from a change in interest or tax rates, or it could be an intended consequence of the original agreement. On the other hand, if the employer agrees to pay the amount it earns (after-tax) from a specified investment and it actually makes the investment, there is an identity between the employer's rate of return and the amount paid to the employee, even if rates change. Appendix II compares the effects of the immediate and deferred deductions when interest rates change.

In sum, it appears that in the absence of a sale of the business, the potential of changes in interest rates or a difference between the interest rates of the employer or the employee and the rate inherent in the agreement is not a substantial cause for concern. However, the opportunity to exploit a difference between a higher tax rate applicable to the employee and a lower rate paid by the employer is a major weakness in this approach.

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34. If the deferred compensation were immediately deductible and includible and the interest element were explicitly neither taxed nor deducted, the compensation would be properly accounted for at the appropriate tax rate. In addition, while the profitably of the transaction might be affected by an unanticipated change in the rate of return, the rate of return would, in the absence of a sale of the business, be irrelevant for tax purposes because, under this approach, interest is explicitly not taken into account.

2. *Sale of the Business.*—If a sale results in a deduction for the seller without a corresponding income inclusion by the payee, the matching of income and deduction is violated. The foregoing discussion suggests that if the deduction is properly calculated and no deduction is allowed for subsequently accruing interest on the deferred liability, matching is primarily important as a check on the parties' ability to select a low tax year for the employee and a high tax year for the employer. If the seller can accelerate its deduction only in connection with a sale of a business, this may not be a serious concern. Symmetry in the treatment of interest income and interest expense can be maintained through the buyer.

In the earlier discussion, it is assumed that the interest rate available for the buyer's investments is the same as the rate inherent in the deferred compensation agreement and that the present value of the obligation is known. In that case, to continue to match the treatment of the employee, the buyer should get basis equal to the present value of the assumed liability and should not get a deduction for any additional amount paid. How should this be affected if the buyer can earn a higher (or lower) rate of return than is inherent in the obligation?

If present value is determined with an interest rate that is higher than the rate under the agreement, the amount of liabilities assumed, and hence the purchase price, is overstated. For the seller, the amount realized on sale is overstated as is the offsetting deduction for compensation, but this is not a problem unless capital gains are specially treated. For the buyer, however, the purchase price—the buyer's basis—is inflated at no cost because the overstatement of the liability means there is a corresponding understatement of nondeductible interest. Thus, establishing the correct interest rate is more important here than it is with respect to liabilities for which the seller has obtained tax attributes.[35] However, under current practice, a change in interest rate from that reflected in the agreement is presumably not taken into account.

IV. CONTINGENT LIABILITIES INCLUDED IN BASIS

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

35. For example, with respect to the liability to Bank *B*, a discount rate lower than the interest rate on the loan causes an overstatement of the purchase price and an understatement of deductible interest. See text accompanying infra note 123. The same thing happens here, but the shift is more serious since it is from nondeductible interest to amortizable purchase price.

the contingency is resolved.[36] Thus, I believe that the treatment of contingent liabilities should in principle be the same as that applied to the liability to *E*, including denying an interest deduction to P.

The difficulty of this approach might depend upon how two ancillary issues are resolved. First, must the basis adjustment be made at the time of purchase, or can it await actual payment (or if the contingency is the only reason for the delay, the liability becoming "fixed")? Under present law, no amount is added to basis until the liability is determined, and, apparently, none of the payment is treated as interest to compensate for the deferral.[37] Second, what is the appropriate treatment when it is determined that the obligation was assumed but the amount turns out to be much larger or smaller than the parties anticipated? In that case, does the basis adjustment still reflect the *expected* amount of assumed liabilities?

I turn to the latter question after first considering the circumstances under which a liability should be considered to be assumed.

A. *Determining Whether a Liability has been Assumed*

The law is unclear about how to distinguish between assumed liabilities and post-sale liabilities incurred by the buyer. Several tests have been suggested that appear logical if the goal is to determine the expected value of the assumed liabilities. This goal is most clear if the decision turns on whether the liabilities were reflected in the purchase price.[38] But, it can also be what the courts have in mind when they ask whether the liability was expressly assumed[39] or whether the buyer was aware of the liability.[40]

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36. Under the all events test, a deduction is not allowed until the "fact" of the liability is determined and the amount can be determined with "reasonable accuracy." Regs. § 1.461-1(a)(2)(I). In these circumstances, deferral may be required to prevent the seller from overstating the amount of the liability.

37. Temp. Regs. § 1.338(b)-3(c); Keyes, supra note 2, § 21.04[2][b][1]; Schler, supra note 2, at 616, 622.

Some have suggested that if the seller retains the liability and the buyer agrees to make additional payments to the seller equal to the payments that the seller eventually makes to discharge the liability, the buyer could treat part of the deferred payment as deductible interest. Schler, supra note 2, at 671; Wootton, supra note 2, at 737-38. The buyer might prefer this approach since it allows some of the payment to be deducted immediately, rather than being capitalized as basis. However, it may convert part of the seller's capital gain into interest income, and it may also increase the gain reported for the year of the sale because part of the seller's basis would be used against the deferred selling price. Thus, it is not clear whether the overall tax burden would be reduced or not.

It seems to me to be senseless to give the parties this alternative when, under the terms of the deal, the risks have not changed; the buyer is assuming the risk as to the amount of the liability just as it would if the seller were out of the picture.

38. Keyes, supra note 2, § 21.04[1][e].

39. Id. § 21.04[1][f].

Other standards seem more appropriate if the goal is to determine whether a particular liability, rather than a particular amount, was assumed. One possibility is to consider whether the event giving rise to the liability (e.g., the manufacture of a defective product or the release of toxic wastes) took place before the sale.[41] Another is to determine when the legal liability arose (e.g., customer injury from defective product or a new environmental statute).[42] However, the existence of legal liability does not necessarily reduce the value of a business. For example, a liability to pay rent under a long term lease or wages under an employment contract does not diminish value if the rent or salary is consistent with the benefit to be received.

Just as the presence of legal liability at the time of sale is not inconsistent with future value, the absence of such liability does not necessarily indicate that the item did not affect the purchase price. Consider costs incurred by the buyer to pare back the seller's workforce (severance pay) or facilities (payments to a landlord to cancel a lease). Liability may not arise until the buyer discharges employees or terminates the lease, but if the buyer expects to take this course, it is reflected in the amount it is willing to pay.

Also, the future costs of providing medical benefits for retirees may reduce the value of the business, even if legal liability does not exist at the time of the sale because some employees have not satisfied the conditions for vesting or the employer has a unilateral right to amend or terminate the plan. On the other hand, the buyer might believe that the cost of a retiree medical program, or other fringe benefits based upon past service, might be recoverable out of future income. Since the existence of the plan might enable the employer to spend less on wages, total future compensation costs might not exceed the value of future services. If this is true, liability under the plan does not reduce the value of the business.[43] This might explain the belief that contributions to qualified pension plans, even if on account of service prior to the transfer of the business, should not be considered an assumed liability.[44]

These examples suggest that the appropriate distinction is whether the potential liability relates to past or future income. If so, potential product liability or warranty claims with respect to goods sold before the sale of the

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40. Id. § 21.04[1][c]. However, in Pacific Transp. v. Commissioner, 483 F.2d 209, 213 (9th Cir. 1973), rev'g per curiam, 29 T.C. Memo (CCH) 133, T.C. Memo (P-H) ¶ 70,041 (1970), cert. denied, 415 U.S. 948 (1974), the court stated that if the buyer was aware of the potential claim, it did not matter that the liability proved to be far greater than anticipated.

41. Keyes, supra note 2, § 21.04[1][b].

42. Id. § 21.04[1][d].

43. See NYSBA, supra note 2, at 892-93, 896.

44. Keyes, supra note 2, § 21.04[1][f]; Youngwood, supra note 2, at 769. See also G.C.M. 39274 (Apr. 23, 1984).

business should be treated as acquisition costs, even if no injury has yet occurred.[45] But, if the goods have not been sold when the business is sold, any resulting liability should be deemed to be incurred by the buyer.[46]

Suppose that inventory can be sold for $100, the buyer expects to incur future costs of $20 ($15 for storage and selling expense and $5 for product liability), and wants to have a profit of $10. In these circumstance, the buyer should be willing to pay $70 for the inventory. If the future costs become part of the basis for the inventory, perhaps very little would turn on whether or not these are considered assumed liabilities.[47] However, it seems to me that they are not. Basis for the inventory should be $70, and the costs should be deducted by the buyer, even if the defect relates to manufacturing done by the seller.[48]

In any event it seems that present law is unclear, not only in application but also as to the underlying principle. I consider next whether the treatment of errors in estimating assumed liabilities sheds any light on this matter.

B. *Amount of Basis Adjustment*

The discussion thus far, which suggests a distinction between costs related to past profits and those related to future income, seems to apply to fixed as well as contingent costs. It does not answer the question of what to do if amount of the liability is estimated incorrectly. For example, if instead of paying $106 to *E*, *P* actually pays $120, is the appropriate addition to basis still $100?

Suppose the production of previously sold goods resulted in environmental damage, or these goods contain a carcinogen; either the parties were unaware of the problem, or the law that created the liability was not anticipated.[49] If the seller had retained the business, it's profits from these sales

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45. Professor Charlotte Crane has suggested to me that a seller may make good on warranties in order to enhance its reputation, thereby enabling it to charge a premium in future sales and show an adequate profit, even taking the warranty cost into account. This is analogous to past service pension liabilities being considered a current cost because they enable the employer to pay lower wages.

46. See Rev. Rul. 76-520, 1976-2 C.B. 42 (disallowing deductions for costs to fill prepaid subscriptions the income from which is taxable to the seller but allowing deductions for costs relating to post transaction newsstand sales). See also Keyes, supra note 2, § 21.04[1][a]; Youngwood, supra note 2, at 770.

47. It would matter, however, if the buyer uses a LIFO inventory method.

48. Youngwood seems ambivalent, supporting this result as to warranty costs but suggesting, or perhaps fearing, that it would not apply to product liability expense. See Youngwood, supra note 2, at 780.

49. See Youngwood, supra note 2, at 778. Youngwood suggests that if the liability derives from a post acquisition statute, it cannot be an assumed liability. But, the parties' ignorance of the carcinogen's existence would not preclude this liability from being treated as

would have been less than it originally believed. The sale of the business preserves the seller's expected profits and shifts the liability to the buyer. Since these costs relate to past income of the seller and not future income of the buyer, are they assumed liabilities, even if not anticipated?

In the case of a purchase price that is contingent upon the performance of the acquired assets, it is clear that the amount actually paid is the purchase price. But this amount is, at least in some sense, the true value of the business ex post, even if it is not the value expected at the time of the sale. In contrast, when contingent liabilities exceed the amounts estimated at the time of the sale, this does not indicate that the purchased assets are worth more than anticipated.

I do not believe that we would adjust the selling price to give the seller additional capital gain and ordinary deductions to reflect an unexpected increase in liabilities,[50] and it seems to me, therefore, that the increase should not affect the purchase price either. It may not be meaningful to ask whether the buyer has paid more for the business than it expected or just suffered an unanticipated additional cost of future operations. However, it is certain that even if it is an additional cost of the acquisition, it does not enhance the value of the business, and at least an unrealized loss has occurred. It seems sensible to recognize this loss by allowing the buyer a deduction for liabilities not reflected in the purchase price. Conversely, if the buyer pays less than anticipated, it should have current income, reflecting the bargain purchase, and not just a reduced purchase price, resulting in less in the way of cost recovery.

In sum, in these circumstances, expected liabilities seem clearly to be a better indicator of value. Since the amount expected to be paid on the liabilities is what is reflected in the purchase price and the amount of cash transferred, it provides the right answer, at least in principle, to the question of what has been assumed. Thus, I believe that the correct price adjustment is the expected value of the liabilities.[51] While the section 338 regulations

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assumed. See David R. Webb Co. v. Commissioner, 708 F.2d 1254, 1256 (7th Cir. 1983) (stating that it is not relevant whether liability is known).

50. Wootton, supra note 2, at 739-40. A look back to the "seller" may make sense in the context of a § 338 election since buyer and seller are one economic entity. However, this is not true in the case of a § 338(h)(10) election, where the impact falls on the original seller.

51. In the example, this amount is $100 if basis is determined at the time of purchase. If, as discussed below, the basis adjustment is deferred until payment, the basis addition should be $106 (the estimated present value ($100), increased by the expected rate of return). If *P* pays, say, $120 to *E*, and payment of this expense would normally be immediately deductible, the buyer should be entitled upon payment to a deduction of $14. If the buyer only pays $80, the purchase price adjustment should remain at $106, requiring the buyer to report $26 of ordinary income.

suggest that the price is adjusted as the amount of contingent liabilities is fixed, the IRS could probably modify its position, despite some case law to the contrary.[52]

However, it should be considered whether this approach, which requires an estimate of contingent liabilities, can be administered; that is, is it substantially more difficult than looking to the amount ultimately paid on account of the assumed liabilities? The next two sections consider this matter in more detail.

C. *Price Adjustment for Expected Value*

If expected value is relevant, the liabilities must be valued at the time of the transaction. It is claimed that the amounts of the contingent liabilities intended to have been assumed is not usually apparent from the negotiations.[53] While I have not had enough transactional experience to be sure, it seems to me that the parties must have some amount in mind that cannot be completely hidden. For example, some evidence might be provided from accounting records or the agreement of sale.

To implement the approach suggested here, the buyer's basis for the purchased business should include, from the outset, an amount equal to the present value of the expected payments on the contingent liabilities. This amount can be computed as a specified series of expected future payments, discounted at the after-tax rate of return.[54] As is true of fixed liabilities, payments of assumed contingent liabilities should not be deductible.

In the case of fixed liabilities nondeductibility extends to the interest portion. Is the denial of interest correct in the case of contingent liabilities?

As discussed above, in the case of deferred compensation, the employer is required to defer the deduction until payment, even if the amount is known, in order to compensate for the delay in the employee's recognition of income. This effectively denies the employer a deduction for interest, just as deferral effectively relieves the employee from tax on investment income. I argue above that unless the buyer is similarly denied an interest deduction, the effort to compensate for the advantage to the employee is thwarted. The

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52. Several authors have supported this approach. James M. Lynch, Transferring Assets Subject to Contingent Liabilities in Business Restructuring Transactions, 67 Taxes 1061, 1070 n.61 (1989); Gregory J. Soukop, Accounting for Assumed Liabilities Not Yet Accrued by the Seller: A Response, 48 Tax Notes 637 (July 30, 1990); Wootton, supra note 2, at 740. Another suggested it as an alternative. Keyes, supra note 2, § 21.04[2][a][I].

53. Thomas H. Yancey, Emerging Doctrines in the Tax Treatment of Environmental Cleanup Costs, 70 Taxes 948, 968 (1992). See NYSBA, supra note 2, at 898 (suggesting that the parties may have different values in mind). But see C. Ellen MacNeil, Glenn R. Carrington & Ross S. Friedman, Dealing With Contingent Liabilities in Taxable Asset Acquisitions, 83 J. Tax'n 208, 209 (1995).

54. See Crane, supra note 2, at 226 (suggesting a need to know the discount rate).

question remains whether this treatment of the buyer should extend to contingent liabilities.

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.[55] However, if, in the absence of the sale of the business, the seller's deduction for the item would have been delayed until payment,[56] 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.

The expected payments on a contingent liability, unlike those under fixed liabilities, may never occur. However, under the approach advocated here, the amount deemed assumed (and included in the purchase price of the business) is based on the expectation at the time of the acquisition, not actual events. If the contingent payments are less than expected, the purchase price is not reduced, but the buyer instead recognizes as income the amounts of expected payments that are not actually made. If the contingent payments are made as expected, they are nondeductible under this approach.

In many instances, it may not be easy to determine which payments by the buyer are made in satisfaction of assumed contingent liabilities. This difficulty argues for modifying the suggested approach to avoid the need to match particular payments with particular liabilities. Therefore, on the dates projected for the expected payments, 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.

If the expected contingent payments are made in a later year than expected, the results would be an inclusion of income in the year the payment was expected with a corresponding deduction, equivalent in present value, in a later year. If tax rates change or there are cash flow problems, the taxpayer may be disadvantaged as compared to a disallowance of the deduction in the year of payment. Perhaps, a taxpayer who can establish that the contingent liability will be paid later than expected could be allowed to follow the latter approach.

It is extremely important to recognize that under the suggested

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55. See Halperin, supra note 5, at 529-30.

56. If the seller would have been allowed an interest deduction, the buyer should be as well. For example, interest on an assumed liability for corporate income taxes should be deductible. See Youngwood, supra note 2, at 781.

approach, a taxpayer could not profit from deliberately overestimating the amount of contingent liabilities, as long as the disallowance of the deduction, or equivalent inclusion, leads to an actual tax payment. The additional basis given to reflect the liability equals the present value of the nondeductible payments of the liability. In effect, for every dollar added to basis, the taxpayer forgoes a future deduction (or is burdened with an income inclusion) whose present value is one dollar at the time of the acquisition. Trading a deduction for a basis adjustment of equal value cannot benefit the taxpayer unless a change in tax rates is anticipated.[57]

There may, however, be some concern that the taxpayer will dissipate assets before the offsetting future tax is due or, perhaps, that a failure to report the correct amount of income will not be easily detected on audit. The suggested approach thus entails a form of credit risk for the IRS.

Another problem is that the results might be distorted by an erroneous discount rate. Under this approach, the taxpayer will effectively be allowed excessive deductions if the present value of the expected payments on the assumed liabilities is determined with a discount rate that is lower than the taxpayer's expected after-tax rate of return. This is almost certain to occur if the after-tax discount rate is computed by converting the rate paid by the United States[58] into an after-tax rate.[59] When the estimated interest rate is too low, either too much basis is given to reflect the assumed liability, or if the basis amount is considered correct, the estimate of the nondeductible future payments is too low. Either way, future deductions are excessive, either in the form of too much depreciation or other basis recovery or too much deduction for future payments. One of the two amounts, which are equal in present value,[60] is unwarranted.

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57. The Treasury objects to a buyer adding to basis the estimated present value of a contingent purchase price. See infra note 66. But in those circumstances, an overestimate would not correct itself as easily as it can when an after-tax interest rate is appropriate.

58. See IRC § 1274(d) (establishing the "applicable Federal rate" (AFR)).

59. Arguably, a pretax rate can be used, even if an after-tax rate is more accurate, as a means of offsetting the fact that the rate (e.g., the AFR) is likely to be low. See Halperin, supra note 5, at 530. There is precedent for doing this. For example, § 468, in adjusting for errors in estimating the cost of mine reclamation or solid waste disposal, assumes earnings at the short-term Federal rate, § 468(a)(2)(B), although an after-tax rate may be more appropriate. See Halperin, supra, at 530-31. Also, in allowing deferral for payments received for dealer warranties, provided that the income inclusions for subsequent years are increased to be equal in present value to the deferred amounts, the IRS uses a pretax AFR for calculating the economically equivalent income inclusion. Rev. Proc. 92-98, 1992-2 C.B. 512, § 5.01.

60. Assume the future payment is estimated to be $106 payable in one year, and the present value (basis adjustment) is computed, using a 6% rate of return, as $100. If the taxpayer is able to earn 7% after tax, it can accumulate $107 from a $100 set-aside. If $100 of basis is correct, the estimated future payments should be $107. If the estimated payment of $106 is correct, the basis should be $99.07 (the present value of $106 in one year at 7%).

The credit risk and discount rate problems could be mitigated by requiring that an amount equal to the assumed liabilities be segregated in a separate fund, which would grow at the actual after-tax rate of return and would be used to pay the liabilities as they became due.[61] Payments from the fund would not be deductible, but once the fund ran out, the buyer could deduct all further payments. Any excess in the fund, after the assumed liabilities are paid, would be included in income, and the fund would be a source for collecting the tax on this income. Since the fund would continue to grow at the after-tax rate of return, there would be minimal advantage to delaying recognition of an excessive set aside.[62]

Another approach would be to require the buyer to include in income, at the time of the acquisition, an amount equal to the basis adjustment for the contingent liabilities and to allow the buyer deductions for all payments on the liabilities.[63] Since the basis amount equals the present value at the time

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Either the taxpayer has taken 93 cents too much basis, or has underestimated the future payment by $1. At the taxpayer's 7% discount rate, the present value of $1 to be paid in one year is 93 cents.

61. See IRC § 468A (using a similar approach). The § 468A fund is restricted in its investment choices in order to curb self-dealing that might reduce the fund's income. IRC §§ 468A(e)(5), 4951. See also Halperin, supra note 5, at 532. For a similar proposal, see Treasury Dep't, Tax Reform for Fairness, Simplicity and Economic Growth ch. 12.10 (1984) [hereinafter Treasury I] (proposing reserve account for property and casualty companies).

62. In our continuing example, the fund would grow from $100 to $106 after one year. If no payment on the liabilities is ultimately required, the amount in the fund would be included in income. Assuming constant tax rates, there is no difference between including $100 in income in year one and $106 in income in year two. Still, there should be some cut-off, perhaps when the buyer cannot establish any remaining contingencies or, in any event, after the passage of a specified number of years.

63. This approach was used in Rev. Rul. 71-450, 1971-2 C.B. 78. See Crane, supra note 2, at 228 n.9. For the treatment of the seller in the situation involved in the ruling, see James M. Pierce v. Commissioner, 326 F.2d 67 (8th Cir. 1964).

The approach in the ruling has been defended on the grounds that the buyer has in effect received a payment from the seller for agreeing to assume liabilities (in the form of a purchase price reduction) and that this payment should be taxable, just like an insurance premium would be. The buyer, like an insurer, can then deduct the costs of carrying out its agreement. However, the approach has been criticized as not reflecting economic reality. See Lynch, supra note 52, at 1068-69; NYSBA, supra note 2, at 897.

I offer it more in the way of a mathematical offset. Since the payments that the buyer should not be able to deduct cannot easily be distinguished from other payments, the buyer would be allowed to deduct everything but be subject to an extra tax equal to the tax savings from the unwarranted deductions. For example, a deduction of $106, one year after the sale, produces tax savings of $42.40. If cash flow is not a problem, the deduction compensates the buyer for the extra tax of $40 paid one year earlier as a result of the inclusion in income of the estimated amount of assumed liabilities ($100). If the buyer borrowed $40 at 10% interest, it would owe $44 and would obtain $1.60 in tax savings from the interest deduction.

of the sale of the expected future payments on the assumed contingent liabilities, including this amount in income at that time is the equivalent of disallowing deductions for the expected future payments.[64] Thus, the buyer can be allowed to deduct all payments of liabilities that would have been deductible by the seller, without regard to whether they have been assumed.

However, neither of these alternatives may be well enough understood to be feasible, particularly since both of them would probably require legislation. Thus, the assumption of a credit risk by the IRS and the potential for taxpayer advantage from understating the rate of interest may not be avoidable.[65]

D. *Price Adjustment for Amounts Paid*

We could, as the IRS suggests, adopt a wait and see approach, delaying the buyer's addition to basis until the amount of the liability is fixed and thereby making it unnecessary to measure the expected value of contingent liabilities.[66] The major challenge in the implementation of this proposal may be to counter pressure from the IRS to treat liabilities as assumed when they should be considered the buyer's liabilities. Thus, as

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64. Since the income inclusion effectively takes away the benefit of the future deductions at the time of sale, regardless of the interest rate, it obviates the need for making an interest rate assumption to determine the amount of future deductions to be disallowed.

65. To determine whether, given the interest rate problem, this approach is preferable to the alternative of ignoring contingent liabilities, we need to compare the potential doubling of basis and expensing for part of the purchase price under this approach with the expensing of everything, which is the result of the alternative proposal. If the result of a too-low interest rate is seen as being excessive basis, as would be true in the case of fixed liabilities (in the example in note 60, basis should have been only $99.07, not $100 as claimed), the matter can be analyzed by estimating the present value equivalent of the cost recovery allowed for a typical purchase price and determining by how much the estimated purchase price would have to exceed the actual price in order for the present value of cost recovery of this excess to be better than expensing, or 100%. Whether the latter is likely to happen depends upon the period involved and the amount by which the actual return exceeds the assumed rate.

If the basis is considered correct, the taxpayer obtains an unwarranted expense deduction. (In the example in note 60, $107 should be disallowed, not $106.) By how much again depends upon the period involved and the interest error. Quantifying the potential taxpayer advantage involves a comparison of this extra deduction to the typical difference between expensing and the present value of cost recovery. The estimated advantage to the taxpayer would be greater under this second approach. (The present value at the time of the sale of an extra $1 deduction one year later is 93¢. An additional deduction of 93¢ is more beneficial than the same amount added to basis.)

66. This corresponds to the treatment of a contingent purchase price under the § 338 regulations and the proposed regulations on contingent payment obligations. See Prop. Regs. § 1.1275-4(c)(4)(iii)(B)(6) ex. 1(iv). The option of expensing does not apply in that situation.

discussed above, we would need to develop a standard to determine whether particular payments satisfy assumed liabilities, which should be added to basis, or are expenses of the buyer, which can be deducted.

While the basis adjustment is deferred, its value could be kept constant. In the example we have been using, ideally, *P* should take a $500 basis at the time of the purchase from *S*, including $100 for the assumption of the liability to *E*, and no part of the payment of $106 should be deductible. However, equivalent results can be obtained by stating *P*'s basis as $400 initially and increasing it by $106 at the time of payment to *E* if, as described below, the allocation of the purchase price and the timing of depreciation are properly determined.

In neither case does the buyer get a deduction for interest. If it gets basis of $100 at the time of purchase and no deduction for the payment of $106, it is explicitly denied tax credit for the additional $6 in the nature of interest. If it adds $106 to basis one year later, it appears to take account of the interest element, but $106 is merely the future value of $100, increased by the after-tax rate of interest to compensate for the delay.[67] Thus, the $6 effectively remains nondeductible.

Whether purchasers would be disadvantaged by the deferred basis alternative might depend upon how often basis adjustments are made and upon the allocation of the basis additions among various assets. Under the regulations, the noncontingent purchase price is first allocated to cash and marketable securities in an amount equal to market value.[68] The remainder of the purchase price is allocated to "Class III" assets—all other assets, except goodwill and going concern value—in proportion to their values but not in an amount exceeding fair market value. Any remaining cost is allocated to goodwill and going concern value. It is assumed that with the enactment of section 197, the regulations will be amended to redefine the residual category to include all assets subject to section 197.[69]

If the purchase price, without regard to contingent payments, exceeds the fair market value of assets other than goodwill and other property subject to section 197, then any subsequent adjustment will be to the basis of intangible assets, which have a uniform amortization period of 15 years. In these circumstances, adjusting basis at the time of payment may not be particularly troublesome, even if, as discussed below, a new 15-year period begins each time there is a basis addition.

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67. See supra text accompanying note 14.

68. Temp. Regs. § 1.338(b)-2. See Youngwood, supra note 2, at 772 (describing method of allocation).

69. H.R. Rep. No. 111, 103d Cong., 1st Sess. 776 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 1007.

The adjustment is more difficult if the noncontingent consideration allocated to Class III assets is less than fair market value, for at least two reasons. First, if this occurs, there will be basis adjustments, perhaps recurring basis adjustments, potentially to numerous Class III assets, including inventory, accounts receivable, and depreciable property. Second, merely allocating an amount to bring the basis of these assets up to their fair market value at the time of sale, and depreciating this amount over the original recovery period, does not produce the correct result. Both fair market value and the recovery period must be adjusted.

In the example, the deferred basis approach provides the buyer with basis of $106 one year after the sale, in lieu of $100 at the time of the sale. As noted, these two amounts are equivalent in present value. Assume that if added to basis at the time of the purchase, the $100 would have been allocated to a depreciable asset that has a five year recovery period and is worth $100 at that time. If the basis adjustment is deferred, *P* will have depreciation deductions of equivalent value only if $106 is added to the basis of this asset one year later and is recovered over five years from the time of payment, not from the acquisition date.[70] To permit this to occur, fair market value at the time of the sale ($100) must be adjusted by an assumed after-tax rate of return (e.g., 6%) to determine the equivalent value at the time of payment ($106).

These suggestions for an increase in the fair market value (which probably helps taxpayers) and a new recovery period for each basis addition (which clearly harms taxpayers) might appear odd and not consistent with present practice.[71] It is probably even odder when cost recovery occurs on the asset's disposition. In that case, if the basis arises one year after purchase, the larger basis offset should be allowed one year after sale.[72] Perhaps, an

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70. Each amount claimed as depreciation would be one year later and 6% larger than if $100 were added to basis at the time of sale. See Halperin, supra note 5, at 537. As shown in the case of the deduction for deferred compensation, the increase compensates for the delay. Alternatively, $106 could be discounted back to the point of sale to create a retroactive $100 increase in basis at that time, but this approach would require reopening earlier returns every time a basis adjustment occurs.

71. The IRS suggests that cost recovery should occur over the original period, with the amounts allocable to years prior to the year of the basis adjustment being spread over the remaining period. Prop. Regs. § 1.168-2(d)(3). See Temp. Regs. § 1.338(b)-3(d); H.R. Rep. No. 111, 103d Cong., 1st Sess. 772 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 1003; Schler, supra note 2, at 611.

There is no indication that the IRS would adjust the fair market value.

72. Halperin, supra note 5, at 537 n.118. In this case, since it would not affect past years, it would be simpler to discount the amount to be added to basis back to an equivalent value at the time of the business acquisition. Adding this lower amount to basis would allow the basis offset to be taken into account at the time of sale. However, it would be to the taxpayer's advantage to understate interest in order to increase the addition to basis.

acceptable compromise is to forgo both adjustments, making the deferred basis adjustment for only the original fair market value and writing it off over the remainder of the original amortization period. Generally, the results of this compromise would be to allocate too much basis to goodwill and to write off the added basis over too short a recovery period.

V. IGNORING CONTINGENT LIABILITIES

A. *The Proposal*

Because of the difficulty in valuing assumed liabilities and the apparent complexity of the approach discussed in Part IV, some commentators propose ignoring the assumption of contingent liabilities in determining both the amount realized by the seller and the buyer's basis.[73] Those advocating this approach would place the buyer in the seller's shoes and allow the buyer a deduction at the time and in the amount to which the seller would have been entitled had the business not been sold.

Thus, if the liability to *E* were contingent, the transaction described in the example would be analyzed as through *P* purchased assets from *S* for $400, rather than their fair market value of $500. *S*' gain on sale would be $200, and *P*'s basis would be $400. *S* would be allowed no deduction for the obligation to *E*, but payment by *P* would be deductible, just as if the payment were of a liability incurred in *P*'s business. Therefore, it would not be necessary to determine whether the payment related to an assumed liability.

One author makes this proposal because of his fear that the parties would otherwise have an incentive to inflate the amount of the assumed liabilities.[74] Another proponent of the proposal, a committee of the New York State Bar Association, worried that the IRS would otherwise inflate the amount of assumed liabilities to deny the buyer deductions for costs arising after the purchase, claiming that particular payments relate to assumed liabilities and are therefore part of the purchase price that should be added to basis.[75] This explains the committee's proposal that in no case should a contingent liability be deemed to have been assumed by the buyer.

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73. NYSBA, supra note 2, at 891-92; NYSBA, supra note 2, at 891-92; Youngwood, supra note 2, at 784-85. Others suggest that in practice, taxpayers may often follow this course. E.g., Crane, supra note 2, at 226.

74. Youngwood, supra note 2, at 784. As to the buyer, this concern was expressed in the context of a proposal to allow the buyer to increase basis at the time of the acquisition by the amount of contingent liabilities claimed to have been assumed. It was stated that any subsequent correction when the actual amount of the assumed liabilities was determined would not compensate for the time value advantage of the earlier inflated deductions. Youngwood, supra note 2, at 784. But see supra text accompanying note 57.

75. NYSBA, supra note 2, at 891-92. Those who had this concern apparently assumed that basis would not arise until the liability is paid.

B. *Treatment of Seller*

In the case of the seller, relatively little may turn on the total amount of liabilities assumed. *S*, which sells assets with a basis of $200 for $500, should have gain of $300, and it should also be entitled to a $100 deduction for the liability. Under the alternative proposal, no deduction would be allowed, but only $200 would be reported as gain. The understatement of the gain may have the same effect as a $100 deduction for the seller.[76] In the relatively rare circumstance where payment of the liability would never be deductible (e.g., a fine[77] or a federal income tax liability), the proponents modify their proposal to add these liabilities to the amount realized.[78]

Thus, at least if capital gain is not differentiated from ordinary income, *S* is in the same position as if the assumption of the liability were taken into account in measuring the selling price and *S* were allowed an offsetting deduction for the deferred compensation. If capital gain is more favorably treated[79] and liabilities were taken into account, the seller would have an incentive to overstate the amount of assumed liabilities, increasing both capital gain and ordinary deductions; since the gross sales price and offsetting liabilities would be equally inflated, the cash received would not be affected, but the tax picture would be improved.

C. *Treatment of Buyer*

In the case of the buyer, the amount of the liabilities claimed to be assumed, and the tax treatment afforded them is nearly always important. The proposed treatment, which ignores contingent liabilities on the sale of a business, would be more favorable than the treatment of fixed liabilities or of contingent liabilities assumed other than in connection with the purchase

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76. This approach makes it unnecessary to determine whether the deduction should be allowed at the time of the sale or at some other time. For example, if contingent liabilities are taken into account and the transaction is not reported as an installment sale, the seller's gain is recognized at the point of sale, but the deduction could be deferred, perhaps until the contingency is resolved (although it has been settled as far as the seller's exposure is concerned) or due to the application of § 404(a)(5).

77. See IRC § 162(f).

78. NYSBA, supra note 2, at 891 n.87; Youngwood, supra note 2, at 784.

79. Capital gains may be taxed at a lower rate. See IRC § 1(h) (applicable only to individuals). Also, capital gains may effectively be untaxed because they can be offset by capital losses that might otherwise be wasted.

Ignoring liabilities may result in an unusable capital loss, while taking them into account might have the effect of reducing or eliminating the capital loss and creating ordinary deductions. If capital losses on the sale of a business were allowable without limit, which seems sensible, this would not be a concern.

of a business. This treatment could be viewed as the equivalent of either partial tax-free treatment of an otherwise taxable sale or expensing of the amount of the liability at the time of the purchase. This should be compared with the treatment of fixed liabilities, the assumption of which creates additional basis, which, under the rules for allocating the purchase price, may be allocated to goodwill and amortized over 15 years.[80]

1. *Equivalent of Expensing.*—At first glance, it might appear that reducing the purchase price from $500 to $400 and allowing a deduction for the payment of the assumed liability could make the purchaser better or worse off, depending upon the relative timing of the payment and the amortization of asset basis. If the asset is land, the purchaser is obviously better off under this proposal, but the purchaser might appear to be worse off if, on average, it could amortize its purchase price before it could deduct the payment.

This would be true if the proposal applied to *P*'s assumption of *S*' liability on the loan obtained from *Bank B*. If this liability was ignored in determining *P*'s basis and *P* was allowed to deduct its principal payment to *Bank B*, *P* would be better or worse off than with its treatment under present law (inclusion of the liability in basis and no deduction for the payment), depending upon whether the recovery of basis would on average be later or earlier than the time of the loan payment. In either case, accrued interest would be deductible.

However, the liability to *E* differs from the bank loan because, as explained above,[81] interest on this obligation is effectively nondeductible. *P*'s assumption of the liability should increase the purchase price and its basis by $100, as in the case of the bank loan, but, unlike that case, it should get no interest deduction when it pays $106 to *E*. The proposed alternative treatment is that in lieu of a $100 addition to basis and no further deduction for interest, *P* should be allowed to deduct the payment to *E* of $106,[82] just as *S* would have been allowed to do had the sale not taken place. Thus, we are not comparing an addition to basis of $100 with a delayed deduction of $100. Rather, the delayed deduction of $106 is economically equivalent to an *immediate* deduction of $100. As described above, allowing *S* to deduct $100

80. See supra text accompanying note 68.

81. See supra text accompanying notes 14-15, 37, 67.

82. Suppose the contingent liability is for an environmental cleanup cost, the payment of which the IRS would require to be capitalized and for which the amortization period is unclear. In this case, if the buyer steps into the seller's shoes, the basis resulting from the payment should be allocated to this item, leaving the buyer in more or less the same situation under the alternative proposal as it would be if contingent liabilities were taken into account at the time of the purchase.

at the time of sale is equivalent in present value to the $106 deduction it would have had one year later if the sale had not taken place.[83] When there is no sale, the deduction, although deferred, is increased by the after-tax rate of interest, which compensates for the delay. Similarly, if the purchaser is allowed to deduct $106 one year after the purchase, its position is the same as if it were allowed a deduction of $100 at the time of purchase.

Thus, $100 of additional basis is less valuable than a deduction of the $106 payment in one year, even if the basis would be recovered by depreciation or amortization before payment occurs. Because the basis adjustment approach would deny interest, the purchaser would always be better off under the alternative proposal unless the entire purchase price is immediately deductible, in which case it is *indifferent* between the two approaches.

2. *Carryover Basis.*—It is argued, however, that despite this advantage, the proposed treatment would not create an incentive to sell the business since the tax results would be approximately the same as if the business had not been sold.[84] This assertion is correct because the proposal is equivalent to a partial carryover basis transaction; in return for the buyer accepting a basis below fair market value, the seller is allowed to avoid part of the gain. How can this be explained?

Under the proposal, the deduction for contingent liabilities is deferred until the time it would have been allowed had no sale taken place. If buyer and seller are taxed at the same marginal rates, the value of the deduction is not changed by the sale. The proposal reduces the selling price and hence the seller's gain,[85] but the purchaser's basis is reduced by the amount of the unrecognized gain. The latter results are equivalent to a partial carryover basis. As in a tax-free reorganization with a complete carryover of basis, there is no effect on revenues and no tax-created incentive to sell if buyer and seller are taxed at the same rate.

D. *When Does It Apply?*

Since this approach does not accurately measure income, its application would presumably have to be restricted to transfers of entire

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83. See supra note 22 and accompanying text.

84. NYSBA, supra note 2, at 895; Youngwood, supra note 2, at 785.

85. Since the deduction for the payment of the liability is allowed to the buyer, not the seller, the reduction of the gain to $200 can be viewed as a partial exemption, not an offsetting deduction. Assuming identical rates, it is also equivalent to the seller recognizing an additional $100 of gain and the buyer obtaining an immediate write-off for the same amount, which is how the transaction is analyzed in the immediately preceding section.

businesses in order to prevent abuse.[86] This restriction would make it necessary to distinguish that event from a more casual sale of assets.[87]

Also, because fixed liabilities would be less favorably treated than contingent liabilities, it would be important whether a liability is fixed *or contingent* at the time of an acquisition. Under the all events test of existing law, a liability is fixed when all events have occurred that establish the fact of liability and the amount can be determined with reasonable accuracy.[88] However, the line between fixed and contingently liabilities is anything but clear,[89] particularly in light of two recent Supreme Court decisions. The Court held that an obligation to make a specified payout to unknown future players of a slot machine was fixed, even though the casino could avoid liability by terminating its business before the winning combination was played.[90] A year later, the Court held that liability under a self-insured medical plan was contingent until employees filed claims.[91]

Because of various deduction-deferring rules, including the requirement of economic performance,[92] it is often not necessary under existing law to determine whether the all events test is satisfied. In particular, it is generally not relevant whether deferred compensation is contingent because, under section 404(a)(5), such amounts, even if fixed, cannot be deducted until paid.

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86. For example, consider a taxpayer that owns vacant land with a basis equal to its value of $1 million and also has contingent liabilities with an expected value of $750,000, the payment of which by the taxpayer would be deductible. Assume the land is sold for $250,000 in cash and an assumption of the liabilities. If the liabilities are ignored, the buyer has a basis of $250,000 for the land and can deduct the liabilities when paid. The effect may be to allow the buyer to deduct most of the cost of nondepreciable land while the buyer continues to own the land.

The treatment of the seller may not be clear. Would the seller have a capital loss on the sale of $750,000 (amount realized of $250,000, less adjusted basis of $1 million)? Or, would the seller have no gain or loss on the sale and a deduction for the liabilities when paid? The former treatment, which converts the seller's deduction from ordinary to capital but accelerates it, might add to the tax advantages flowing from the transaction, particularly if the seller is a corporation (enjoying no rate preference for capital gains).

87. For the meaning of the term "trade or business," see Regs. § 1.461-4(d)(5)(ii); Schler, supra note 2, at 611-13.

88. IRC § 461(h)(4); Regs. § 1.461-1(a)(2).

89. See generally Accounting Methods: General Principles, 302 Tax Mgmt. (BNA) at A98-A113 [hereinafter Accounting Methods]; Lee G. Knight & Ray A. Knight, The Deductibility of Expenses for Accrual-Basis Taxpayers: Continued Controversy Under the All-Events Test, 15 J. Corp. Tax'n 245 (1988).

90. United States v. Hughes Property, Inc. 476 U.S. 593, 601 (1986) (finding the all events test to be satisfied).

91. United States v. General Dynamics, 481 U.S. 239, 244 (1987) (finding the all-events test not satisfied).

92. For the requirement of economic performance, see § 461(h).

If this issue must be faced for the purpose of deciding the treatment of the buyer, it could raise some difficult questions. For example, is liability under a deferred compensation arrangement contingent if it is based upon the return from a hypothetical investment? While the payout is uncertain, the deferred compensation is sometimes set aside and invested in the measuring asset. In these circumstances, the employer's obligation is fixed at the amount set aside. Would the line depend upon whether there was a set aside, and if so, how closely it tracked the measuring asset, or would the liability in all these circumstances be fixed because the amount can be determined with "reasonable accuracy"?

Further, although an obligation to pay a retired employee or her beneficiary $50,000 per year for 10 years is certainly fixed, suppose the payment continues for the life of the employee or the employee and her spouse. Would this be considered contingent because the amount could not be definitely determined?[93] At least if the employer has a large number of these arrangements, a fairly accurate measurement is possible.

In general, even if the total amount to be paid to a group can be measured with reasonable accuracy, the "fact" of the liability is not established until particular individuals have "vested" rights.[94] For example, one court denied a deduction for a projected tort liability, even though it was agreed that the taxpayer's exposure clearly exceeded the limit on its self-insurance.[95] Although the total amount was known, it was still necessary to establish which claimants would eventually be paid and how much. Similarly, an obligation to provide vacation pay to all employees at the end of year one who remain employed until June 30 of year two might be considered contingent since it cannot be established which employees will become entitled to vacation pay.[96] It seems odd, however, to treat these obligations very differently from fixed liabilities because the buyer has a pretty good fix on the amount it will have to pay for both tort liability and vacation pay.

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93. The IRS appears to believe that a liability based on life expectancy is contingent. See ISP Coordinated Issue Paper, 92 Tax Notes 113-43 (June 1, 1992). There is, however, contrary authority. See Accounting Methods, supra note 89, at A-107-8.

94. See, e.g., Brown v. Helvering, 291 U.S. 193, 201 (1934); Accounting Methods, supra note 89, at A-100-01, 108. But in *Hughes*, a liability was accrued even though the identity of the eventual lucky gambler was not known. Hughes, 476 U.S. at 601. The Court apparently relied on the fact that the State enforced the casino's obligation to make the payment. Id. at 593.

95. Supermarkets General v. United States, 537 F. Supp. 759 (D.N.J. 1982)

96. See Accounting Methods, supra note 89, at A-101.

VI. EVALUATION AND CONCLUSION

A. *The Alternative of Expensing by the Buyer*

Ignoring the assumption of contingent liabilities would make it unnecessary to determine the amount of assumed liabilities or whether a particular payment is in satisfaction of an assumed liability or one that arose after the transaction. This method would also eliminate subsequent basis adjustments each time a contingency is resolved.

On the other hand, this approach requires distinguishing between the sale of a business and other asset transfers, which may not always be easy. It also treats fixed and contingent liabilities differently, even though the factual distinction between them may be slight. Moreover, because the difference is narrow, it probably can be affected by the actions of the parties,[97] which may lead to economic distortion and possibly manipulation as the parties seek to cloak liabilities as contingent. For example, suppose the parties, desiring to keep the risk of contingent liabilities on the seller, provide that if the buyer's payments on assumed contingent liabilities exceed a certain amount, the cash payable by the seller is reduced dollar for dollar.[98] Since less cash changes hands between buyer and seller as more is paid by the buyer on the assumed liabilities, the purchase price is unaffected by the amount of the liabilities.[99] For purposes of the proposal to ignore only contingent liabilities, the liabilities should be considered fixed in this case. However, treating the liabilities as fixed in these circumstances would create a tax incentive to shift the risk to the buyer to take advantage of the more favorable treatment of contingent liabilities.

Finally, this proposal most likely understates income. A sale of appreciated assets is an occasion to recognize that appreciation, and the recognition of gain produces net revenue to the fisc if the buyer's cost recovery is deferred.[100] Ignoring contingent liabilities is equivalent to a carryover basis approach. While this approach mitigates the tax bias against sales, "under an income tax with realization, the fact of a sale is supposed to

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97. Wootton, supra note 2, at 741; Youngwood, supra note 2, at 785 (suggesting that the line is not clear and stating that if a liability is contingent only as to time of payment, it should be regarded as fixed).

98. Unless the seller is entitled to additional cash if the liabilities are less than the specified amount, the buyer's obligation is contingent up to the specified amount.

99. As this occurs, the seller should have an offsetting deduction.

100. This assumes that the seller is immediately taxed at ordinary rates. If the seller's gain is not taxable or can be deferred or taxed at lower capital gain rates, a sale can cause a net loss in tax revenue, particularly if the buyer gets a rapid write-off of asset basis.

make a difference."[101] The ultimate question is whether the difficulty involved in taking account of contingent liabilities justifies a departure from the realization principle through converting a taxable transaction into one that is partially tax free.

B. *Including Assumed Liabilities in Basis*

I have discussed two methods of taking account of contingent liabilities—an estimate of the amount assumed at the time of sale or deferring the adjustment until liabilities are fixed.

1. *Estimated Liabilities.*—This approach has been opposed because of the difficulty of measurement. However, as explained earlier,[102] taxpayers would have little incentive to exaggerate these liabilities since any overestimation would cost an equivalent amount in deductions. The parties may attempt to underestimate the amount assumed because, as shown above,[103] the omission of a contingent liability from basis, coupled with the eventual deduction for payment of the liability, has the effect of an immediate deduction for the omitted amount. However, this possibility does not seem to be a serious problem, given that the alternative is to omit all contingent liabilities from basis and allow deductions for all payments on these liabilities.

The estimated liabilities should be the amount that is actually taken into account by the parties in measuring the purchase price. This provides a principled distinction between liabilities deemed assumed and post-acquisition liabilities incurred by the buyer. While payment of the assumed liabilities would not be deductible, it is not essential that particular future outlays be matched with the liabilities deemed assumed.

Finally, creating basis equal to the expected amount of assumed contingent liabilities is consistent with the likely treatment of fixed liabilities,[104] and should alleviate the need to distinguish between fixed and contingent debt.

Taxpayers could game the system by underestimating their true discount rate or by overestimating liabilities and defaulting on the tax due on

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101. Crane, supra note 2, at 227. The NYSBA response to Crane's comment evidences a misunderstanding of the effects of their proposal. See NYSBA, supra note 2, at 894-95. To the extent a seller has an alternative to gain recognition (e.g., a sale of stock in the case of a C corporation), one might be more tolerant of carryover basis.

102. See supra text accompanying note 57.

103. See supra text accompanying notes 81-83.

104. But see supra note 28 (discussing whether a delayed basis adjustment would be required in some circumstances).

the correction of the overestimate.[105] These problems could be alleviated by either segregating assets equal to the expected amount of liabilities assumed or immediately including this amount in income, although these two methods probably would both require legislation, which may be difficult to obtain.

2. *Deferred Basis Adjustment.*—Taking account of the actual liabilities as they are paid, rather than the expected liabilities at the time of the acquisition, appears simpler since no estimate is required. Further, a delay in the addition to basis need not affect value if current practice is changed in two ways—by adjusting the fair market value limit on basis allocation to account for the delay in creating basis (which probably helps taxpayers) and by beginning a new amortization period each time a basis addition is made (which clearly hurts taxpayers).[106] While it is probably within the IRS' power to make these changes, they might not easily gain acceptance. Perhaps, making these adjustments elective would be an acceptable compromise,[107] even if it allows all taxpayers to choose the most favorable approach at the cost of having to compute the benefits of both alternatives. Any advantage to taxpayers who don't elect is at least not as favorable as full expensing.

Some commentators are troubled that deferring the basis adjustment would cause excessive gain to be reported if inventory is sold or accounts receivable are collected before the adjustment occurs. But, a similar result would occur under the proposal to ignore contingent liabilities.[108] In that proposal, the amounts paid on the liabilities would be deductible, perhaps after the inventory is sold or the receivables are collected, but similar results would occur under the deferred basis approach to the extent the basis adjustment is allocated to inventory or accounts receivable. In addition, if fair market value is adjusted as suggested above, the delay would be offset by a larger basis at a later point.[109]

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105. See supra text accompanying notes 58-64.

106. See supra text accompanying notes 66-72.

107. Alternatively, if the taxpayer can be prevented from understating its rate of return, the taxpayer could be allowed to discount the basis adjustment back to the point of sale and file amended returns. See supra note 70.

108. This leads to the suggestion that the seller retain accounts receivable or inventory. Lynch, supra note 52, at 68; see Youngwood, supra note 2, at 784-85.

109. Assume that if the contingent liability was taken into account at the point of sale $200 would be allocated to the basis of inventory, but because the basis reflecting contingent liabilities is deferred, the inventory initially takes a basis of $100. The inventory is quickly sold for $220, yielding a profit of $120, which is overstated by $100. When the contingent liabilities are determined, an additional amount will be added to the basis of inventory (and immediately deducted if the inventory has been sold). If this occurs one year later, under our interest rate assumption, the maximum additional basis will be increased to $106. A $106 deduction in year 2 exactly offsets $100 of income in year 1. If the taxpayer borrowed

On the other hand, this approach depends upon a workable distinction between fixed and contingent liabilities if the former, as seems likely, are taken into account at purchase.[110]

Moreover, and most importantly, to avoid excessive additions to basis of amounts that should be expensed by the buyer, this approach requires an administrable distinction between the buyer's own liabilities and those it has assumed. As suggested above,[111] the starting point in determining whether a liability has been assumed could be whether the income to which the expense relates is earned before or after the sale.

This could be subject to some rules of thumb, particularly for employee compensation, in order to ease administrative difficulties. For example, liability for wages and fringe benefits might be considered not to have been assumed unless the expense clearly relates exclusively to pre-transaction events, such as bonuses based on an earlier year's performance,[112] individual deferred compensation arrangements for previously retired or deceased employees (or where it is clear that amounts have been set aside out of the covered employee's wages),[113] costs related to a prior plant closing or a funding deficiency with respect to a qualified plan.[114]

In addition, consistent with my belief that the purchase price should reflect only anticipated liabilities, if the event that gave rise to the liability was wholly unknown and unanticipated at the time of sale, the resulting liabilities should not be considered to have been assumed.

$40 to pay the tax (40% rate), at the assumed rate of return (10%), it will owe $44 in one year. The interest deduction for $4 will save $1.60 in tax, for a net cost of $42.40. A tax deduction for $106 generates $42.40. To this extent, the result is no different than if the alternative proposal were adopted and the payment of contingent liabilities was directly deducted.

In accordance with the earlier discussion of depreciation (text accompanying notes 70-71) if the payment is one year after the acquisition, the inventory adjustment should take place one year after the inventory is sold. For this purpose, it is probably reasonable to assume that sales of inventory and collection of receivables occur at the point of sale. Since income is measured over a taxable year and not on a daily basis, these adjustments cannot be perfect. See Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 65-68 (1990); Daniel I. Halperin, Commentary, in Life Insurance Company Taxation: The Mutual vs. Stock Differential 5-2, (M. Graetz ed., 1986).

110. See supra note 28.

111. Supra text accompanying notes 38-46.

112. Youngwood, supra note 2, at 778-79.

113. David R. Webb Co. v. Commissioner, 77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983). Cf. M. Buten & Sons, Inc. v. Commissioner, 31 T.C. Memo (CCH) 178, T.C. Memo (P-H) ¶ 72,044 (1972) (allowing deduction for payments to beneficiary of deceased employee where death occurred after the acquisition). Even payments to previously retired employees could be intended to impart a sense of security to the current work force and, thus, provide future value.

114. Youngwood, supra note 2, at 770.

C. *Resolving the Issue*

1. *The Seller.*—If the seller would have been allowed a deduction for its payment of a liability, the buyer's assumption of the liability should have no net tax impact for the seller because any inclusion of the liability in the amount realized should be offset by a deduction for the amount so included. Some commentators have suggested that sellers often ignore contingent liabilities despite the absence of any law allowing them to do so.[115] Also, to the extent that sellers must, or actually do, include assumed contingent liabilities in the amount realized, it is not clear that they are allowed offsetting deductions. While the regulations waive the economic performance requirement in these circumstances,[116] the IRS has not taken a position with respect to contingent liabilities and has enforced specific statutory rules deferring the deduction until receipt by the payee (e.g., section 404(a)(5).

It does not seem sensible to keep the seller in the picture after the sale, leaving its amount realized from the sale and, perhaps, deductible expenses to be determined by future events over which it has no control and about which it may have no information.[117] Thus, if contingent liabilities are to be taken into account, they should be accounted for by estimate at the point of sale for the purpose of determining both the selling price and the deductible expense.

If the seller would have been allowed a deduction for its payment of an assumed liability, the only difference between ignoring and accounting for the liability is the possible trade off between ordinary deductions and capital gain. It seems best to avoid that quagmire whenever possible.

Thus, as to the seller, I believe the best treatment is to ignore at least those liabilities that cannot be definitely valued. In order to avoid distinguishing between fixed and contingent liabilities, this treatment might be extended to those fixed liabilities that will lead to future deductions. Since this would deprive the seller of a capital gain advantage, it may require legislation.[118]

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115. NYSBA, supra note 2, at 893; Youngwood, supra note 2, at 782.

116. Regs. § 1.461-4(d)(5).

117. See MacNeil, Carrington & Friedman, supra note 53, at 211.

118. Arguably, allowing the seller to take liabilities into account would create a tension between seller and buyer that might lead them to agree on more accurate measurements of assumed contingent liabilities. The seller would try to inflate the amounts of these liabilities so as to maximize ordinary deductions, at the cost of additional capital gain, while the buyer, as discussed in the text below, would want to minimize the amounts.

It seems more likely, however, that the parties would resolve this tension in a way that minimizes tax overall. That is, if the seller gains more from reporting capital gains and claiming ordinary deductions than the buyer loses from adding to basis in lieu of expensing, the parties would maximize assumed liabilities. Conversely, if the cost to the buyer is greater than the seller's gain, the liabilities would be minimized. I see no point in creating tension if the likely result is reduced tax revenues.

Even with this legislation, however, the seller could retain the opportunity for capital gains by continuing to be responsible for the debt.

2. *The Buyer.*—The IRS suggests that when assumed contingent liabilities become fixed, the buyer must adjust basis by the actual obligation, with no provision for interest, and that the new basis is amortized over the remainder of the period beginning at the point of acquisition for assets of that category.[119] This may also be the result with respect to fixed liabilities where statutory rules prohibit deduction until payment. But, basis is adjusted at the time of the acquisition for other fixed liabilities.

While this approach does not require estimates of the amounts of assumed contingent liabilities, it does distinguish between assumed liabilities and those incurred by the buyer. The almost total absence of litigation over this very difficult issue suggests that taxpayers have engaged in self-help and ignored contingent liabilities or, at least, that the IRS has not been active in this area.[120]

An alternative would be to require an immediate basis adjustment for fixed liabilities and for contingent liabilities whose amounts can be determined with reasonable accuracy. In other circumstances, taxpayers could be allowed to defer the basis adjustments until payment. Taxpayers fearing that the IRS would insist on excessive basis adjustments could be allowed to elect the expected liability alternative, which I prefer, perhaps conditioned on protecting tax revenues by either a segregation of assets equal to the liabilities deemed assumed or an immediate recognition of income in this amount.

D. *A Last Word*

My stated goal in this article is to set out the issues surrounding the assumption of contingent liabilities so that policy makers can make informed choices that appropriately balance administrative feasibility and consistent application of income tax principles. This requires increased understanding of the impact of the time value of money.

I have shown that ignoring contingent liabilities is equivalent to partial tax-free treatment of an otherwise taxable transaction and can also be described as immediate expensing of a portion of the purchase price. Such generosity to taxpayers needs stronger justification than has been offered.

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119. See supra note 66 and accompanying text.

120. Because of fear that IRS activism may lead to basis additions far beyond the amount of liabilities assumed, it has been urged that the practice of ignoring contingent liabilities should be confirmed and legitimatized. See Part V. It seems to me that the latter approach is more generous than its supporters have recognized and is not required by valuation difficulties.

On the other hand, recognition of contingent liabilities as part of the purchase price is not as problematic as may be believed. Deferral of a basis adjustment until payment need not affect its value, although it does require that assumed liabilities be distinguished from the buyer's liabilities, which is difficult both in principle and in application.

This problem, however, is avoided if assumed liabilities are estimated at the point of sale. Taxpayers have much less to gain by exaggerating this amount than is probably believed. Underestimation remains a concern, but this concern cannot make this approach less desirable than the alternative, which would ignore contingent liabilities and effectively value them as zero.

None of the approaches discussed is easy; no approach can be simple as long as we have a realization-based income tax. This has led some to advocate a move to a consumption tax. While a *pure* consumption tax would be simpler than a *pure* income tax for businesses (although not necessarily for individuals), I believe that because of issues relating to fairness and transition, a consumption tax in any form is highly unlikely to be adopted. Certainly, a simple consumption tax that treats all forms of investment income alike will never happen. For me, the road to reform is improvement in the income tax, primarily efforts to extend the application of mark to market[121] or other mean of currently accounting for investment income and loss, so as to minimize the importance of realization.

APPENDIX I

Liabilities For Which Tax Attributes Exist

It is generally thought that liabilities assumed in the sale of a business are taken into account at face, rather than market value.[122] However, the failure to account for the difference between the face amount and value of a liability could understate or overstate interest income and deductions. For the seller, this error is offset by an equal error in the measurement of the selling price and thus is relevant only if there is a difference in treatment between capital gain and ordinary income. For the buyer, it affects the relative amounts allocated to interest expense as opposed to the basis of the assets purchased, and is relevant whenever the timing of interest on the liability differs from the timing of basis recovery. This appendix discusses this issue for liabilities whose tax attributes are recognized before the sale (e.g., ordinary borrowings and liabilities deducted on accrual before the sale).

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121. See, e.g., Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347 (Sept. 11, 1995).

122. For a more detailed discussion of this issue, which is outside the main thrust of this article, see Shrago, supra note 7, § 19.05 at 19-11.

If interest rates have risen since the liability was incurred, the seller could possibly discharge the liability at a discount, and the buyer could not borrow the face amount at the stated interest rate. In these circumstances, the reduction in the cash price to reflect the assumption is likely less than the face amount of the liability.

If this fact is not recognized and the selling price is considered to be the sum of the cash transferred and the face amount of the liability, the seller's amount realized is overstated, and the seller avoids income from the discharge of indebtedness. These amounts are offsetting unless the seller enjoys more favorable treatment of capital gains. For the buyer, the purchase price (basis) is exaggerated, but interest expense is understated by the difference between the amount really borrowed and the larger amount to be repaid. Whether this is an advantage depends upon the length of the loan term as compared to the period for cost recovery of the asset to which the additional purchase price is allocated and upon the cost recovery devices used for the loan and assets. The excess purchase price may be allocated to goodwill or another intangible asset subject to section 197.[123] Some suggest, however, that it could be attributed to "favorable financing," and written off over the life of the loan (essentially as additional interest expense).[124]

If interest rates have fallen, the seller would have to pay a premium to prepay the debt, and the buyer could borrow more than the face amount of the debt at the stated interest rate. In this case, treating the purchase price as the sum of the cash transferred and the face amount of the liability understates the seller's amount realized, but deprives the seller of an equal deduction for the premium. In the absence of a capital gain advantage or capital loss disadvantage, these amounts offset. The buyer's basis is understated, and the buyer has excessive interest deductions because of the failure to take account of the bond premium, the amortization of which would effectively reduce its interest cost to market.[125]

In sum, if interest rates have risen, the buyer understates interest and overstates the purchase price, while the seller is understating ordinary income and overstating gain, which could be capital gain. If interest rates have fallen, the buyer overstates its interest deductions and understates the purchase price, while the seller could be understating capital gain and overstating ordinary income.

However, even in the absence of an assumption of liabilities, the parties may have a similar opportunity to misstate interest income and

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123. Id. § 19.04 at 19-9.

124. Id. § 19.04 at 19-7 to 19-8.

125. The buyer can accelerate the deduction for this interest by paying off the debt. See Shrago, supra note 7, § 19.04 at 19-10.

expense.[126] In the case of a deferred payment of the purchase price, interest need not be provided at a rate higher than the applicable Federal rate (AFR),[127] which is likely to be less than the market rate faced by the buyer.[128] If the AFR is used, the buyer probably understates interest expense and overstates the purchase price, while the seller understates interest income and overstates gain, which could be capital gain. Since there is no statutory rule fixing a maximum rate,[129] the parties might also have an opportunity to overstate interest and understate the purchase price. Apparently, because of the difficulty of a subjective determination of the true interest rate implicit in each transaction, a decision has been made to live with this distortion.

Given this determination, it generally seems unnecessary to try to achieve an accurate interest rate in the case of an assumption. However, it seems sensible to adjust the interest rate on an assumed liability if it is less than the AFR.

One additional issue involves the treatment of nonrecourse liabilities, which, by statute, must be included in the selling price at face.[130] When interest rates have risen, the sum of the other consideration and the face amount of the debt exceeds the fair market value of the property.[131] For the seller, this could again be said to result in overstatement of the amount realized and understatement of discharge of indebtedness income.[132] In the buyer's case, although there is authority to include the liability in basis to bring basis up to fair market value, normally when the sum of other consideration and the face amount of contingent liability exceed the value of the property acquired, basis does not include the amount of the liability.[133] If the basis is effectively limited to the cash outlay, the purchase price is understated. This does not appear appropriate in these circumstances since the buyer still has an economic incentive to pay the liability, which it is valuing at fair market value.[134]

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126. Keyes, supra note 2, § 21.03[2] at 21-10.

127. IRC §§ 483, 1274.

128. IRC § 1274(d) (basing the AFR on the average yield on Treasury obligations of comparable length).

129. The IRS has the power to reduce above-market interest in the case of a "potentially abusive transaction." IRC § 1274(b)(3); Prop. Regs. § 1.1274-1(d). See Schler, supra note 2, at 645.

130. IRC § 7701(g).

131. See Shrago, supra note 7, § 19.05[2] at 19-16.

132. Tufts v. Commissioner, 461 U.S. 300, 319 (1983) (O'Connor, J., concurring).

133. See Shrago, supra note 7, § 19.05[2] at 19-16.

134. Id.

APPENDIX II

Impact of Difference Between Discount Rate & Rate Inherent in Agreement

In order to focus on differences between the assumed discount rate and that faced by the parties, the discussion in the following paragraphs assumes that the tax rate at the time of payment is the same as when the liability arose.

A. *The Employer*

If the employer were granted a deduction for the deferred compensation when it was earned, it could invest the tax savings at its after tax rate of interest. When the deduction is deferred, the tax savings increase by the rate of return inherent in the arrangement, which might not be the employer's after-tax rate.

The deferred deduction is worth more than an immediate deduction for an employer who credits the employee with more than it actually earns and is less valuable for an employer who increases the employee's benefit by less than its after-tax rate of return. If the original intent was to credit the employee at the rate earned, there is no reason to expect actual results to be biased in either direction. Moreover, the deduction could be viewed as correct if the employer's investment return is said to have increased or decreased the compensation, as the case may be.

An employer who originally intends to pay the employee at a rate less than it expects to earn would (all other things being equal) be worse off with the deferred deduction than if it paid cash compensation and borrowed or otherwise obtained equivalent funds from the employee or other sources. By borrowing elsewhere, it would benefit from the spread in rates without reducing the value of its tax deduction for compensation. One reason not to be concerned about the effect of a deferred compensation arrangement in these circumstances is that the spread in rates could occur because the employer is not currently taxable and it retains the benefit of the tax exemption by offering the employee the equivalent of an after-tax rate of return.[135] This opportunity would not arise if it borrowed in a way in which the interest would be taxable.

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135. One might expect the interest rate to be somewhere in between the normal cost to the employer and the normal expectation of the employee, depending upon the bargaining power of the parties. On the other hand, in the case of deferred compensation arrangements for senior executives, one might expect the rate to be set at the employer's after-tax return with the entire differential being captured by the employees.

An employer who sets out to pay the employee more than its expected rate of return benefits from the deferral of the deduction because the tax savings from the deduction increases at the higher rate reflected in the agreement. It seems, however, that such an arrangement cannot really exist. An employer who purports to do so seems to be effectively increasing the amount of compensation and providing interest in line with its own expected earnings, in which case there is no additional advantage from deferral.

B. *The Employee*

In order to compare the employee's status to the position she would have held if she paid the tax up front and then received a tax-free return at the rate provided by the arrangement with the employer, we need to consider whether the employee would have paid the tax out of her savings or by borrowing. If she would have paid out of savings, we need to know the rate of return she earns on her savings. If she would have borrowed, we need to know the rate of interest she would have had to pay.

An employee who would have paid the tax from savings is better off doing so, in lieu of deferral, if her after-tax rate of return is less than what she obtains from the employer. In that case, when tax is postponed, her retained savings are insufficient to pay the deferred tax. She comes out ahead with a deferred tax only if she earns more than is provided through the deferred compensation.

An employee who would have borrowed gains from the deferral if the interest rate she would have had to pay exceeds the rate provided by the employer. In that case, the amount that she would have owed on the loan (including interest) at the time the deferred compensation is paid exceeds the tax on the deferred compensation.

Since the employee may not have funds to pay the tax and may likely have to borrow at more than she will earn from the arrangement, the benefit of deferred compensation for the employee may exceed that which would be achieved merely by accounting for compensation when earned and ignoring investment income and the interest paid. This would not be true, however, if the employer distributed enough to pay the tax. It would have to be recognized, moreover, that the latter approach has its own difficulties. It would require that the present value of the compensation be determined, which is always difficult, and perhaps not possible, with respect to contingent liabilities. Further, the employee could abuse that approach by setting the interest rate unrealistically high, thereby understating the true compensation.

Thus, on balance, the prospect of a difference in discount rates should not cause the deferred deduction approach to be considered more problematic unless there is a transfer of the business.