ALIGNING INTERESTS IN THE SALE OF A BUSINESS: FINANCIAL AND INCOME TAX TRAPS ESTATE PLANNERS NEED TO KNOW (PART 1)

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CHAPTER ONE

Analysis of the Financial and Income Tax Aspects When an Earnout Is Used for the Sale of a Business[1]

When a buyer and seller cannot agree upon a price for a business, an earnout is generally used and may result in selling the business for less than its true value. This chapter of the article will discuss how earnout formulas can be adjusted to ensure that true value is paid. This chapter will first apply the contingent payment installment sale and contingent payment Original Issue Discount (OID) rules to illustrate the income tax treatment of earnouts. Because earnouts can sometimes result in adverse income tax treatment to the seller, this chapter will then illustrate how the adverse income tax treatment can occur and go on to discuss how to eliminate these adverse income tax results.

I. WHY USE AN EARNOUT?

The sale of a business is complex and dynamic. The parties to the transfer of a going concern are subject to many variables and risks, both known and unknown. If the absolute value of the business were determinable, there would be little need for earnouts. However, that is seldom the case. There may be liabilities that over time will reveal themselves but may not be known at the time of the sale. There may be changes anticipated in the way the business will be run that could impact the bottom line but whose impact will only reveal itself over time. There may be circumstances where the seller is needed to play an ongoing role in the business that can impact future performance. Likewise, the seller may need to step aside from existing relationships and abstain from competition. Each of these features, and more, can warrant an earnout because they can impact ultimate results of operations and profitability. A well thought out earnout can provide a bridge to meet the different expectations of the seller and purchaser as well as a method to adjust for the risks (and rewards) that may be unknown at the time of the sale. The earnout can also provide incentives so that the parties to the sale will behave in a manner that maximizes the outcome.

The income tax and financial consequences of the different types of earnouts are varied. The tax advisor should play a key role in structuring the transaction to achieve the optimal balance and to avoid hidden perils. One purpose of this paper is to sensitize the advisors to all the factors, both financial and income tax, that impact the sale terms and must be considered when the sale of an operating business is involved.

An earnout can have certain tax advantages. For example, if there is a desire that the sellers refrain from competing, a non-compete clause can accomplish that objective. However, payments allocable to a non-compete agreement are viewed as compensation for services, not only characterized as ordinary income to the recipient, but also subject to employment taxes. And, the buyer cannot take a current deduction for non-compete payments. Instead, they must be capitalized as Code section 197 intangible and amortized over 15 years. An alternative may be to give the seller an earnout that provides a strong disincentive for the seller to compete but will be taxed to the recipient as capital gain. This is not necessarily an all or nothing proposition. But, the earnout may enable the parties to reduce the payments under a non-compete while preserving the optimal balance of incentives and income tax consequences. Likewise, a seller retained as a consultant or key employee may be willing to accept a lower level of compensation if he or she retains an earnout. Again, the benefits of using an earnout rather than relying exclusively upon an employment or consulting contract are significant—the difference between ordinary income rates and capital gains rates.

An earnout may be structured to fine tune a business deal in a manner that may not be plausible with a fixed price. For example, the business may have a greater value to the buyer than to the seller. It is not uncommon for a competitor or other industry player to acquire a business for a price that exceeds the standalone value of the target business. For example, the purchaser may be able to eliminate overhead of the seller by using the purchaser's existing infrastructure. Or, the buyer may have an

existing customer base that can be readily used by the buyer's distribution network, thus increasing its profitability. These types of objectives can be the impetus for paying the seller more than the seller can earn had he or she retained the operating business. However, the buyer may mitigate the risk of these speculative economies by paying a reduced fixed price to the seller plus an earnout so the seller can participate in the upside while minimizing the risk to the purchaser.

The earnout may simply serve to bridge the gap between the purchaser and the seller because the seller is taking a lower level of risk on the contingent payments under an earnout. A fixed sale price will always be lower than the amounts the seller may receive with a contingent element – assuming the contingent targets are achieved.

Lastly, there may be residual items such as contingent liabilities or indemnities that are not reduced to a liquidated sum but which may have to be paid in the future. Negotiating these items out of the deal so that the purchaser assumes responsibility for these items may result in a lower price for the seller. Therefore, these items bear similarity to earnouts even if they are not strictly defined as such. An earnout or sharing agreement for these items needs to be properly structured to avoid potentially dire tax results (as will be explained below).

When an earnout should be used and the earnout terms will vary depending upon the circumstances, such as:

- The seller and the buyer cannot agree upon a value for the operating business or feel uncomfortable relying upon a valuation report prepared by a qualified appraiser
- The seller will continue to participate as part of the operating business after it is sold, and the buyer desires to provide the seller with an incentive to actively participate and grow the business
- The seller will not participate after the business is sold but can impact future performance directly or indirectly and ensures that the seller will not divert future customers
- The seller and the buyer should share the risks of underperformance and the benefits of increased profitability
- The business has a different value to the buyer because the buyer can reduce costs through economies of scale or the buyer has a distribution channel that can increase sales

There follows an illustration of how an earnout can be used when the seller and the buyer cannot agree upon a fixed purchase price. This illustration also points out that an earnout that is not well thought out may result in the seller shifting value to the buyer without receiving any compensation in return.

When negotiating the sale of an income-producing commercial asset or a business, it is not unusual that the parties have differing perceptions as to its value. The buyer may feel that the seller's asking price is inflated, while the seller continues to feel that the asking price is fair. The differing perceptions can be resolved using an earnout arrangement. In such a situation, the parties agree on a minimum value, but allow for the payment of additional amounts based on the future profitability or future performance of the business. For example, the buyer could be required to pay a specified percentage of future earnings more than a certain threshold amount. The earnout protects the buyer from overpaying for the business because the post-sale performance determines the final amount paid for the business. Similarly, the seller should not be shortchanged if the business is as valuable as the seller believed.[2]

The financial problem with an earnout is that even an earnout negotiated in good faith by the seller and by the buyer can result in the seller inadvertently shifting value to the buyer because neither party understood the financial implications of the earnout terms. One purpose is to demonstrate how to evaluate the factors used in an earnout and how they need to be structured so that the seller receives fair value for the business and so that the buyer does not overpay for the business.

Example: Seller feels the business is worth $12 million because of the potential for future growth. Buyer feels the business is worth only $8 million because the buyer is only looking at prior earnings and feels that future growth is too speculative. An appraiser hired by Buyer used a 10 to 1 price earnings ratio and applied that 10 percent capitalization rate to the $800,000 current earnings for the business to arrive at an $8 million value for the business. Seller believes that the business is capable under its current structure of averaging $1.2 million of net income before taxes in the future. Using the same 10 to 1 price earnings ratio, Seller feels the business is worth $12 million.

Since Seller and Buyer cannot agree on how to come up with an immediate dollar amount to value the potential for future growth, they compromise and agree to an earnout. Buyer agrees to pay $8 million in cash at the closing and pay over to Seller a fixed percentage of future income in excess of $800,000 each year over a fixed term. Assume the earnout provides that Buyer will pay 50 percent of all net income more than $800,000 for the next 8 years.

Over the period for the earnout, the net income and earnout payment to seller is:

YEAR	NET INCOME	EXCESS INCOME OVER $800,000	EARNOUT PAYMENT TO SELLER
1	$900,000	$100,000	$50,000
2	1,000,000	200,000	100,000
3	1,100,000	300,000	150,000
4	1,200,000	400,000	200,000
5	1,300,000	500,000	250,000
6	1,400,000	600,000	300,000
7	1,300,000	500,000	250,000
8	1,400,000	600,000	300,000
	Total earnout payments:		**$1,600,000**

It turns out that Seller's assumption that the business profits will increase to $1.2 million was not overly optimistic and that the profitability of the business even exceeded Seller's expectations. So, Seller's feeling that the business should have been valued at $12 million was substantiated. Therefore, Seller should have received an additional $4 million upon the sale of the business. By using an earnout that was not well thought out, Seller only received an extra $1.6 million, thereby unintentionally shifting $2.4 million of value to Buyer.

How could the earnout be structured so that the Seller received fair value for the business?

As the financial literature notes, the use of earnouts in today's mergers and acquisitions climate is fraught with risk and, as will be explained later, can result in the conversion of what should have been capital gain into ordinary income.[3]

The typical earnout is designed to have both the buyer and the seller bear the risk if profits are less than expected and share in the financial benefits if profits are more than expected. Given the objective of an earnout, the advisor needs to consider what terms should be added to the earnout so that both the buyer and the seller are treated fairly and equitably?

The remainder of this chapter will discuss some of the income tax sensitivities of earnouts and point out some key pitfalls that need to be addressed in structuring them.

II. THE INCOME TAX TREATMENT OF EARNOUTS

Given that an earnout involves a future payment that may not occur and even if it will occur in the future, the amount is uncertain, an earnout is a liability treated as a contingent liability for federal income tax purposes. The first part of the tax discussion will examine how fixed liabilities are treated when they are retained by the seller or transferred to the buyer. The second part will examine the income tax treatment when the liabilities are contingent. Finally, this article will examine the income tax treatment when the contingent liabilities are earnouts.

When a business or an investment asset is sold, it usually involves the simultaneous transfer of liabilities and obligations associated with the property transferred. It is axiomatic that any liabilities transferred by the selling party have the same basic tax effects as the payment of an equivalent amount of cash received by the seller. Therefore, when a liability is transferred to the purchaser of an asset, the seller must include as part of the amount realized any transferred liability which has previously been considered for tax purposes,[4] and the purchaser includes the transferred liability in determining the basis of the property acquired.[5] Furthermore, any obligation created by the transaction (typically, seller-provided financing) is part of the seller's amount realized and the purchaser's basis.

> *Example:* Seller owns a parcel of vacant land worth $250,000, held as an investment, and agrees to sell it for $250,000. The land is encumbered by an existing $70,000 nonrecourse mortgage. Pursuant to the contract of sale, the purchaser will pay $30,000 of cash at closing. In addition to taking the land subject to the existing $70,000 mortgage, the seller will take back the purchaser's interest-bearing note for $150,000. The seller's amount realized on the sale and the purchaser's basis in land purchased are $250,000. At the time of the sale, Seller "realizes" a $90,000 gain because his basis in the property sold is $160,000.

Since the transaction described in the above example is an "installment sale," it qualifies for the "installment method" under Code section 453[6], and the seller is permitted to report the $90,000 gain realized on the sale under the installment method. A portion of this gain must be reported in the year of sale because there was a payment of the sale price, the $30,000 down payment received at closing, in the taxable year the sale occurred.

The material in the first part of this chapter describes the income tax treatment of deferred payment sales when all the future payments of the sales price are fixed, both as to the amount of all payments (including both principal and interest) and the timing of all payments. If there is a possibility, however remote, as to the amount or the timing of any payment of principal or interest, then there is a "contingent payment" and a different set of installment sale and OID rules apply.

III. INSTALLMENT SALES IN GENERAL

The "installment method" is a method of accounting which defers gain (but not loss) on qualifying sales until the purchaser pays the sales price. The installment method is used to allocate and report the gain as the down payment and the principal payments on the note are made.[7] In determining the portion of each principal payment treated as gain under the installment method, qualifying liabilities are deducted from the selling price to determine the contract price, which then becomes the denominator of the payment allocation fraction.[8] The effect of this computation is to apply the seller's basis in the property transferred first against liabilities, with only the balance allocated against the remainder of the purchase price in determining the gain with respect to each payment of the sale price. When several assets are sold together, the consideration received is allocated ratably among the assets transferred, including those that do not qualify for the installment method, unless the parties or the facts justify another manner of allocation.[9] This creates an incentive, when the facts justify it, to allocate a greater portion of any down payment to assets that do not qualify for the installment method, for example, inventory, to defer a greater portion of the qualifying gain.

Qualified liabilities include obligations associated with the property transferred, whether or not they are secured by the property,[10] but do not include obligations arising as part of the transaction, for example, the seller's brokerage costs.[11] Liabilities incurred in contemplation of the sale, primarily those incurred in order to take advantage of the special basis allocation rule, also are excluded from the qualified liabilities.[12] The effect of these provisions is to match the reporting of the gain with the cash proceeds of the sale and to discourage tax maneuvering to increase the deferral.

Example 1: Seller agrees to sell to Purchaser a parcel of vacant land valued at $250,000. Seller's basis in the land is $160,000. At the time of the sale, the land is encumbered by a $50,000 mortgage. Seller is also obligated to pay a brokerage commission of six percent of the sale price, or $15,000. Under the sales contract, Purchaser agrees to assume responsibility for both the mortgage and the brokerage commission and to pay the balance of the price with a cash down payment of $35,000 and a note of $150,000. The note provides for five equal annual installments of $30,000, together with interest on the note balance, payable annually.

To determine the gross profit on the sale, the brokerage commission is offset against the selling price[13] in determining the gross profit on the sale of $75,000 [$250,000 (stated price) – $15,000 (brokerage commission) – $160,000 (basis)]. It is not, however, a qualifying liability. Accordingly, the contract price is $200,000 (the $250,000 selling price minus the $50,000 mortgage) and the gross profit ratio is 37.5 percent ($75,000/$200,000). The "payments" received by Seller in the year of sale are $50,000, consisting of the $35,000 cash down payment and the transfer of the liability for the brokerage commission. Thus, Seller reports gain of $18,750 in the first year. In addition, 37.5 percent of each $30,000 note payment, or $11,250, is reported as gain, as the principal payments are received.

Purchaser's basis in the land is the $250,000 purchase price. It does not matter that part of the price is paid in cash ($35,000), part by assumption of the brokerage commission ($15,000), part by transfer of the mortgage ($50,000), and part with a note ($150,000).

When the liabilities transferred exceed the basis of the property sold, only liabilities up to the amount of the basis of the property are deducted in determining the contract price. The excess is treated as a fictional payment of cash in the year of the sale.[14] Whenever liabilities transferred exceed the basis of the property transferred, 100 percent of each principal payment on the note is gain. The deemed payment in the year of sale, equal to the excess of the liability transferred over basis, can be avoided by using a wrap-around note to prevent the transfer of the liability.[15] Under a wrap-around note, the seller continues to be responsible for payment of the mortgage or other liabilities related to the property. If, however, the purchaser pays a portion of the deferred price directly to the creditor to protect the purchased property or otherwise obtains too much control over the application of the payments to the liability retained by the seller, the liability may be considered to have been transferred even when the transaction takes the form of a wrap-around note.[16]

Example 2: Seller agrees to sell to Purchaser a parcel of vacant land valued at $250,000. Seller's basis in the land is $60,000. At the time of the sale, the land is subject to a $100,000 mortgage. Under the sales contract, Purchaser agrees to assume responsibility for the mortgage and to pay the balance of the price by issuing a note for $150,000. The note provides for five equal annual principal payments of $30,000 with adequate stated interest on the outstanding note balance. The gross profit, or realized gain, is $190,000. The contract price is also $190,000 (the $250,000 selling price less the $60,000 mortgage, as limited by the property's basis). The $40,000 excess mortgage is a "payment" in the year of sale even though there is no cash payment, and gain of $40,000 is reported. The remaining $150,000 gain is deferred and reported as the $150,000 of note principal payments are received.

Seller can avoid reporting gain in the year of sale by using a wrap-around mortgage in which Purchaser issues a note for the entire $250,000 price and Seller agrees to make payments on the original $100,000 mortgage (i.e., the "wrapped indebtedness") as they become due. The mortgage is not considered to have been transferred so that the contract price equals the selling price. The gross profit ratio is 76 percent ($190,000/$250,000), and this portion of each principal payment on Purchaser's

note is reported as gain even though a substantial portion of each payment is likely to be needed to make payments on the wrapped indebtedness. If Purchaser attempts to ensure that the payments on the wrapped indebtedness are made (for example, by making those payments directly to the lender), the wrapped indebtedness probably will be treated as having been transferred, and the tax result will be the same as described in the first paragraph of this Example.

Ironically, even if the liability is transferred for installment sale purposes under a "failed" wrap-around note, it is not transferred for purposes of applying the OID rules.[17] Accordingly, the determination of whether there is OID is based solely on the terms of the wrap-around mortgage issued by the purchaser. If the mortgage provides for qualifying interest at the Applicable Federal Rate, there is no OID.

Fixed liabilities transferred in an installment sale, including those that represent deductible items, should be treated in the same manner as in a sale with no deferred payments. That is, the deduction cannot be transferred with the property because the purchaser is, in no sense, a successor to the seller, and there is no more reason to defer the deduction than in a fully taxable sale. Even if total liabilities exceed the basis of the property sold, the entire amount of the liabilities, including those that may give rise to deductions, should be considered in determining the sale price. The excess is a payment to the seller in the year of sale, and any deduction allowable under Commercial Security deemed-payment rule[18] should be allowed in that same year. Since the purchaser's basis is not affected by the seller using the installment method, the entire selling price, including all transferred liabilities, are part of the purchaser's basis.

Example 3: Seller agrees to sell to Purchaser a parcel of vacant land valued at $250,000. Seller's basis in the land is $160,000. At the time of the sale, the land is encumbered by a fixed obligation of $50,000 for environmental clean-up costs, which is deductible when paid. Under the sales contract, Purchaser agrees to assume responsibility for the environmental clean-up costs and to pay the balance of the selling price with a cash down payment of $50,000 and issuing a note of $150,000. The note provides for five equal annual installments of $30,000 with adequate stated interest on the outstanding balance.

Under the principles of Treas. Reg. § 1.461-4(d)(5), the transfer of the environmental clean-up costs is the transfer of a liability. Accordingly, the contract price is $200,000 and the gross profit ratio is 45 percent ($90,000/$200,000). Seller reports 45 percent of the $50,000 cash down payment ($22,500) as gain in the year of sale and $13,500 of each subsequent payment as gain, when received. In addition, Seller is entitled to a deduction in the year of the sale for the $50,000 of clean-up costs transferred. If Treas. Reg. § 461-4(d)(5) does not apply, for example, because the fixed obligation is for deferred compensation, the obligation transferred should still be considered in determining Seller's amount realized, selling price and contract price, even though the deduction may be delayed until Purchaser pays the obligation.

IV. CONTINGENT LIABILITIES

The tax consequences are far more complex when the liability transferred or the liability created upon the transfer is contingent.[19]

A. OID Implications

One method of dealing with amounts that may not be paid over in the future is to hold the transaction "open" by ignoring contingent liabilities initially and taking contingent payments into account for income tax purposes only when they become fixed or are paid. The open transaction method was approved by the Supreme Court in the seminal case of Burnet v. Logan.[20] Under the traditional open transaction method, a seller is permitted to treat the receipt of any contingent payment first as a return of the seller's basis in the asset sold, and reports a gain on the sale only if, and when, the seller has recovered his entire basis in the property sold. Conversely, the

buyer obtains a basis for contingent liabilities only as they become fixed or are paid.

The IRS historically opposed the use of the open transaction principle of Burnet v. Logan[21] for purposes of determining gain in cases where there are contingent payments or property with uncertain value.[22] The IRS now generally excludes contingent liabilities transferred from the seller to the purchaser from amount realized and basis until they become fixed.[23] One cynical view of the reason for the IRS's shift in position is that it occurred initially as part of the regulations under Code section 338 which are principally concerned with determining the purchaser's basis, so that the exclusion of contingent liabilities has the principal effect of deferring deductions related to basis. When the temporary Code section 338 regulations were initially adopted,[24] the General Utilities[25] principle provided nonrecognition for substantial portions of the gain of the "old" target. The IRS's opposition to the Burnet v. Logan principle occurs primarily when it concentrates on gain recognition by the seller.[26]

1. Contingent Obligations as Liabilities

There is an initial semantic problem in discussing contingent liabilities. Contingent liabilities are not really liabilities until they are taken into account for income tax purposes. Until then, they have *not* been considered in the basis of any assets, given rise to a deduction or even given rise to an expenditure that is neither deductible nor capital. Thus, "contingent liability" is almost an oxymoron. To be technically correct, we should either refer to contingent "liabilities" or contingent obligations. Both approaches are awkward, to say the least. Whatever the semantic difficulties, the term contingent liability is the one commonly used to refer to the type of obligation with which we are concerned. Accordingly, it is used throughout this article with the understanding that a contingent liability is not a tax liability until it ceases to be contingent.[27]

Although the Commercial Security[28] principle and Treas. Reg. § 1.461-4(d)(5) accelerate taking *fixed deductible* items into account and convert them into liabilities as they are transferred, contingent obligations are different. Fixed deductible items are items that have accrued economically but are deferred for tax purposes because the taxpayer uses the cash method of accounting, because tax policy requires a delay until economic performance has occurred, because principles of tax symmetry require deferring a deduction until income has been realized by the taxpayer on the other side of the transaction or for some other tax policy reason. Contingent deductible obligations are primarily those that are too uncertain to be accrued under the all events test.[29] They simply have not matured for tax purposes,[30] and the sale transaction does not require that extraordinary efforts be made to accelerate them.[31] The same considerations that delayed initial tax recognition of the contingent obligation continue to apply after the sale.[32] Similar considerations delay the tax recognition of capital items and future expenditures that are neither deductible nor capital.[33] That is, the contingency keeps them from being treated as liabilities at the time of sale that can be included in the amount realized and in basis, and the sale transaction itself is not a sufficient reason to take the contingent liabilities into account.[34]

As a general legal matter, the transfer of a contingent liability is oftentimes a bit more complex than the transfer of a fixed liability.[35] The types of items that give rise to contingent liabilities are frequently covered by representation, warranty, or indemnity provisions in contracts of sale or exchange. To the extent that the purchaser is protected by such provisions, the contingent liability has not been effectively transferred.[36] Similarly, to the extent that the purchaser indemnifies the seller against liabilities that are not formally transferred, the liability has been effectively transferred to the purchaser.

a. Original Issue Discount (OID)

When contingent liabilities are not taken into account until they become fixed or are paid, the final determination of amount realized and basis, the application of the deemed-payment principle, and the allowance of any deduction or capitalization are postponed until that time.[37] At that later

date, however, the tax consequences of the fixing of the contingent liability relate back to the earlier transfer, with the result that the amount fixed for the contingent liability now includes an imputed interest or OID element.[38]

The contingent payment OID regulations analyze contingent payment obligations issued for property that is not publicly traded under what is called the "contingent bond method."[39] Under this method, the instrument is separated into two components, one consisting of fixed payments and "quotable" contingent payments and the other consisting of "nonquotable" contingent payments.[40] The contingent payment regulations come fairly close to the results that should occur under common law income tax principles through the sound application of fundamental tax principles,[41] particularly in the case of nonquotable obligations issued for nontraded property.[42] Accordingly, the authors will rely on these final regulations in this discussion.[43]

Nonquotable payments for non-publicly traded property are, in effect, ignored for income tax purposes until they become fixed. When a nonquotable contingent payment obligation issued for nontraded property is paid or becomes fixed, a portion of each contingent payment, including discharge of a contingent liability,[44] is interest because it amounts to a deferred payment related to the prior sale. The amount to be treated as interest for both the seller and the purchaser is determined by discounting the contingent payment, that is the amount fixed or paid on the contingent liability, back to the date of sale at the Applicable Federal Rate (AFR).[45] The purchaser's interest deduction is subject to any applicable deduction limitation, such as Code section 163(d). The interest inherent in the obligation when it is paid or becomes fixed is reported at that time, with any additional OID—from the time the obligation becomes fixed until it is paid—reported under the normal OID rules.[46] The balance of the amount of the obligation is the principal portion, and as such it is an additional amount realized for the seller and additional basis for the purchaser.[47]

The contingent bond method of computing principal and interest for nonquotable payments for non-publicly traded property treats a greater portion of the early payments as principal than would be the case if the interest were computed on the entire stated price and deducted as payments are made, the method used for quotable payments. Further, the contingent bond method is not the same as that provided for allocating payments to the seller in determining installment gain.[48] This inconsistency is difficult to justify[49] and may be unworkable.

The interest and principal (including basis) portions of fixed payments and contingent payments are determined using a projected payment schedule and are subject to a complex adjustment formula if the actual payments differ from the projected ones.[50] If the amounts received are greater than projected, the net excess is additional interest for both parties.[51] If the amount is less than projected, the deficiency is treated first as a reduction in the interest accruals for the year for both parties;[52] then as ordinary loss for the purchaser or ordinary income for the seller, to the extent of prior net interest accruals;[53] then as a carryforward against interest accruals for subsequent years.[54] Any amount not absorbed as a carryforward is a reduction in amount realized for the purchaser and interest income for the seller.[55] The treatment of the seller is inconsistent with §453B(a) that treats gain or loss on an installment obligation as an adjustment of the sale price of the property.[56]

Example 1: Nonquotable contingent payment and OID. Seller owns a business valued at $250,000. Seller's basis in the business is $200,000. The business is subject to a lawsuit that may result in damages capitalizable as a self-created and therefore a nonamortizable intangible. As part of a sales contract to acquire the business, Purchaser agrees to assume responsibility for the claim. Although the ultimate liability, if any, for the claim is not known, Seller and Purchaser agree that $5,000 is a reasonable estimate. The Purchaser agrees to pay any such liability. Based on this estimate, the amount Purchaser pays for the business is reduced to $245,000. Exactly two years later, Purchaser pays $4,000 to settle the

claim. The short-term AFR is 10 percent semiannual interest at the time the sale took place.

The contingent liability is not considered for the year of the sale. Therefore, Seller's amount realized on the sale is limited to the $245,000 paid. Seller initially reports a $45,000 gain on the sale of the business. Purchaser's basis in the business is limited to the $245,000 paid. When the contingent liability becomes fixed, or, as here, is paid two years later, the principal amount of the contingent obligation is treated as an additional payment of the purchase price.[57] The $4,000 is treated as a separate OID debt instrument, and a portion of the $4,000 payment must be treated as interest. Therefore, at 10 percent semiannual interest for two years, approximately $700 is treated as a payment of interest, and the remaining $3,300 is treated as an additional payment for the business. Purchaser increases the basis in the business by $3,300 and deducts $700 of interest, subject to any applicable limitations. Seller reports an additional gain of $3,300 because of the increase in the amount realized and $700 of interest income. Seller is generally treated as making a $4,000 payment. But, because Seller's deemed payment would have been capitalizable, Seller probably has a $4,000 capital loss.

Because the definition of quotable contingent payment is addressed primarily to obligations for which forward price quotes are available,[58] contingent liabilities would rarely, if ever, qualify. Accordingly, except as otherwise specifically stated, the quotable contingent payment method is ignored in the balance of this article and references to contingent liabilities refer to nonquotable payment obligations for non-publicly traded property.

b. Installment Sale

Whenever the contingent liability is not settled until after the year of sale, the transaction is a deferred payment sale that qualifies for the installment method unless the seller elects out of the installment method.[59] The installment method is effectively limited to property that qualifies as a capital asset or a Code section 1231 asset.[60] Even if the installment method does not apply, delayed accounting for the contingent liability has a similar effect of deferring recognition of gain attributable to the transfer of the contingent liability.

When an installment sale of commercial assets involves a contingent price[61] (possibly including a contingent liability), a significant problem arises in allocating the seller's basis in the property among the contingent payments. The three basic approaches for basis recovery under the temporary installment sale regulations determine the gross profit based on the terms of the contingency, that is, whether there is a maximum price, a maximum payment period or neither.[62]

First, if the agreement for the sale provides a maximum selling price, computation of the gross profit ratio assumes that the maximum price will be received, and that, in estimating imputed interest or original issue discount,[63] all contingent payments will be received on the earliest possible date.[64] This dual rule has the effect of maximizing the estimated selling price and gross profit. This, in turn, means that a larger portion of the early payments is gain, and a smaller portion is recovery of basis because a portion of basis is reserved to be allocated to the last possible dollar of contingent payment. If less than the maximum contingent payment is received ultimately, any unrecovered basis is deducted as a loss.[65]

When less than the projected amount is received in an installment sale, under Code section 453B(a), the character of the adjustment is the same as the gain on the sale. Based on the Arrowsmith case, the loss should be characterized by the initial sale transaction, even when the installment method does not apply.[66] The seller may be able to take advantage of Code section 1341(a)(5), but this is far from clear.[67] Code section 1341(a)(5) allows a taxpayer who restores a significant amount which he was required to included in income in an earlier year to computing the tax effect of the deduction in the current year by reference to what the results would have been in the earlier year if the amount had not been received,

in order to avoid the disadvantage of lower tax rates or limited deductibility in the current year.

Second, if there is no maximum selling price for the commercial assets, but there is a maximum term, the seller's basis in the property sold is allocated ratably over the term.[68] In other words, the portion of the annual principal payments that is recovery of basis is determined by dividing the seller's basis for the assets transferred by the fixed term of the purchaser's obligation. All principal payments for each year that exceed the annual basis allocation are gain realized from the sale of the asset. If, in any year, the payments received are less than the basis allocated to that year, the excess basis is not a loss, but is carried forward and may be a loss in the final year with tax effects like those for a maximum-price sale in which the maximum is not realized.

Third, if the sales contract does not limit the amount of the purchaser's obligation and does not limit the periodic payments to a fixed period, the seller can recover basis ratably over an arbitrary 15-year period, commencing with the date of sale.[69] This rule has the potential for distorting basis recovery unless the payments are likely to be received in relatively regular amounts over some fairly long period, and may also result in a final loss with tax effects similar to those for a maximum-price sale when the maximum is not realized. The temporary regulations also caution that a transaction that is literally subject to the 15-year rule may not constitute a sale.[70]

To deal with the basis recovery problems highlighted above, the regulations contain a limited provision for adjustment of the systems provided for basis recovery under the maximum-price, maximum-time and 15-year rule, which can be activated by the IRS either on its own initiative or upon a taxpayer ruling request.[71] The IRS has been relatively liberal in allowing realistic adjustments when there are both fixed and contingent payments.[72] However, an advance private letter ruling is required to accelerate basis recovery and the ruling request must show that under the alternative method, the seller will appropriately recover basis at twice the rate under the prescribed 15-year approach.[73] This may be difficult to demonstrate for contingent liabilities and provides an unnecessary and costly administrative burden.

Thus, the temporary installment sale regulations require that the seller take contingent payments into account under one of the prescribed methods in determining gain, with the effect of accelerating the recognition of gain. These regulations, however, only determine the tax consequences to the seller; the purchaser's basis is determined under the OID regulations. The OID regulations apply because contingent payments almost inevitably involve OID or unstated interest.[74] As indicated, under the OID regulations dealing with nonquotable payments for nontraded property, the contingent payment obligation is, in effect, ignored until the payment becomes fixed. In view of the fact that the latter regulations determine the amount of each payment that is principal and interest for both the purchaser and the seller, the amounts determined under the installment method and the OID rules, particularly for a maximum price sale, may be inconsistent.

Although the contingent payment installment sales rules may work reasonably well for installment sales with express contingent payments when there is an express or implied period for payment, they seem poorly adapted to handle transfers of contingent liabilities because there is no such express or implied period for resolving contingent liabilities. They do not apply, of course, for transfers of contingent liabilities in sales of property excluded from the installment method.

As indicated previously, the regulations under Code sections 338 and 1060 dealing with the allocation of purchase price, in effect, ignore contingent liability transfers (and other contingent payments) for purposes of determining the purchaser's basis and the allocation of the selling price, until such time as the liability (or payment) becomes fixed.[75] Although there are provisions for allocating contingent payments to assets, such as patents and similar "contingent income assets," those rules are not likely to be relevant for contingent liabilities.[76] This allocation of additional consideration is made under a four-class

system that allocates the portion of the purchase price not allocated to cash and other highly liquid assets among remaining assets, other than goodwill and going concern value, in proportion to fair market value, with any residual price allocated to goodwill and going concern value.[77] Under these rules, as a practical matter, the allocation of any price from a contingent liability is most likely to be to goodwill and going concern value or what is now Code section 197 intangibles.[78] Now that most Code section 197 intangibles are amortizable, this may be a favorable result if the alternative is an allocation to long-lived real estate. It remains to be seen, however, what changes the IRS makes in the allocation provisions considering the enactment of Code section 197.[79]

The delayed allocation of basis for the purchaser provided in the Code section 1060 regulations[80] seems to be the most appropriate treatment for a contingent liability that has not been considered sufficiently matured to be taken into account for tax purposes. The same consideration suggests that the seller should not take the contingent liability into account in determining amount realized or even in allocating basis under the installment method. Thus, the delayed recognition of the contingent liability means that instead of allocating basis first to it,[81] no basis should be allocated to it. This application of the Burnet v. Logan basis recovery principle seems entirely justified. When there is no maximum term for payments, allocating the basis arbitrarily over 15 years because of a contingency of this type is ludicrous. Requiring the seller to apply for a private letter ruling is no more sensible. When the parties have placed a specific value on the claim, it might be possible to treat it as part of a maximum price sale. Nonetheless, it is hard to see what this approach has to recommend it. Moreover, the parties rarely place a precise agreed value on contingent liabilities and any rule that imposed significant tax consequences on doing so would further discourage such valuations.[82]

> *Example 2: Contingent liability under installment method.* Seller owns a business valued at $250,000, and his basis in the business is $200,000. The business is subject to a lawsuit that may result in damages capitalizable as a self-created and, therefore, amortizable intangible. As part of the sales contract to acquire the business, Purchaser agrees to assume responsibility for the claim. Although the ultimate liability, if any, for the claim is not known, Seller and Purchaser agree that $25,000 is a reasonable estimate. Based on this estimate, the amount Purchaser pays for the business is reduced to $225,000. Exactly two years later, Purchaser pays $20,000 to settle the claim. The short-term AFR is 10 percent semiannual interest. The contingent liability is not considered for the year of the sale. Therefore, years later, the principal amount of the contingent obligation is treated as an additional payment of the purchase price. The $20,000 is treated as a separate OID debt instrument, and a portion of the $20,000 payment must be treated as interest. Therefore, at 10 percent semiannual interest for two years, approximately $3,550 is treated as a payment of interest, and the remaining $16,450 is treated as an additional payment for the business. Purchaser increases the basis in the business by $16,450 and deducts $3,550 of interest expense, subject to any applicable limitations. Seller reports $3,550 of interest income for that year and the $16,450 principal as additional amount realized. All $16,450 would normally be gain because basis was fully recovered on the original sale, but the deemed capitalizable payment of $20,000 converts this into a $3,550 loss (presumably capital). This result follows because the gross profit ratio determined at the time of sale did not consider the contingent liability so that all basis was allocated to fixed liabilities and other payments.
>
> On the assumed facts of this example, it might be possible to treat the agreed value of the contingent liability as part of a maximum price sale. That approach would result in allocating $20,000 of basis to the contingent liability, increasing gain in the year of sale by that amount, and resulting in a loss of $3,550 in the year of payment. It is hard to see what this approach has to recommend it. Moreover, in real life, the parties rarely place a precise agreed value on contingent liabilities.

2. Deductible Items

Delaying the accounting for contingent liabilities for tax purposes until they become fixed or are paid, does not alter the basic nature of the liability as an obligation of the seller, the transfer of which is part of the purchase price included in the seller's amount realized and the purchaser's basis for the property. Thus, in David R. Webb Co. v. Commissioner,[83] the purchaser of a business assumed a contingent liability to make pension payments to the widow of a former corporate employee based on her life expectancy. Although Code section 404(a)(5) defers the deduction for nonqualified pension obligations until payment, the court refused to allow the purchaser to deduct the payment of the pension benefit. It determined that the payments were part of the acquisition cost of the business to be added to basis only when paid.[84] Although the case did not deal with the treatment of seller, the clear implication is that the seller had an additional amount realized at the time of payment and an offsetting deduction.[85]

Contingent liabilities may add an additional complication if they involve ongoing arrangements or issues, such as deferred compensation for continuing employees, environmental costs or product liability claims.[86] Although the author does not agree with some commentators that this factor justifies allowing the purchaser generally to claim the deduction for the transferred contingent liabilities, it should lead to calling close questions in favor of allowing the purchaser to deduct those items that may reasonably be related to the period after the purchase.[87]

a. Deduction When Contingent Liability Becomes Fixed

In most cases, the circumstances that fix a contingent liability also satisfy the all-events test and the economic-performance requirements or other rules that delay a deduction until paid. If so, the basic results are exactly those that should be expected from applying the rules for fixed liabilities at the time the liability becomes fixed, with appropriate modification for the application of the OID rules at that time, rather than at the time of sale or exchange. The additional amount realized, basis, and related deduction are all accounted for then.[88]

As usual, special rules apply to qualified deferred compensation plans. The IRS has determined, however, that the purchaser is entitled to deduct amounts incurred to fund even past service costs under a qualified plan, on the grounds that the purchaser is not required to maintain the plan, but that it is required to capitalize any assumed responsibility for past funding deficiencies.[89]

Deferring the deduction for a contingent liability transferred until such time as the liability is paid can result in lost deductions if the seller, usually a corporation, ceases to exist before the deduction matures.[90] The maturing of the deduction probably does not affect the shareholders of a liquidated corporation. Although an actual payment of a corporate liability not taken into account in determining gain on liquidation gives rise to a capital loss under Arrowsmith,[91] payment of the contingent liability by the purchaser is on behalf of the corporation, not the shareholders of the seller, and does not increase or decrease the amounts they receive on liquidation. In light of the separate entity of the corporation, the result should be the same even for a liquidated S corporation. Furthermore, the partners of a liquidated partnership and the residuary beneficiaries of an estate or trust should be considered successors entitled to any deduction to which the partnership or trust would be entitled.[92]

> *Example 3: Contingent deductible obligation that becomes Fixed when paid*. Seller owns a business valued at $250,000, and his basis in the business is $200,000. The business sells merchandise backed by a one-year warranty. Purchaser agrees to purchase the business. As part of the sales contract, Purchaser agrees to assume all warranty claims that may arise in the future with respect to any sales that occurred while Seller owned the business. Although the exact cost of the future warranty claims that may arise with respect to sales prior to the sale is not precisely known, experience indicates that the cost of the expected warranty claims will total

$5,000. Based on this estimate, the amount Purchaser actually pays for the business is reduced to $245,000. No warranty claims are made for the remainder of the year of sale. One year later, Purchaser pays $3,960 on a warranty claim presented in 1995 for a sale that occurred prior to the sale of the business. Both Seller and Purchaser use the accrual method of accounting and the calendar year. The short-term AFR is 10 percent annual interest.

The contingent liability is not considered for the year of the sale. Therefore, Seller's amount realized on the sale is limited for the year of the sale to the $245,000 paid, and Seller reports a $45,000 gain on the sale of the business in the year of sale. Purchaser's basis in the business is limited to the $245,000 paid, and there is no deemed payment at the time of the sale. When the contingent liability becomes fixed, or, as here, is paid during the next year, the principal amount of the contingent obligation is treated as an additional payment of the purchase price.[93] At the 10 percent annual AFR, $360 is treated as a payment of interest, and the remaining $3,600 is treated as additional purchase price for the business. Purchaser increases the basis in the business by $3,600 and deducts $360 of interest when the claim is paid, subject to any applicable limitations. Seller reports an additional gain of $3,600 and $360 of interest income for 1995. In addition, Seller is treated as having paid the warranty claim,[94] and is allowed a deduction of $3,960 (the sum of the amount realized and the OID) when the claim is paid, the same deduction that would have been allowed if paid by Seller in the absence of a transfer.

If Seller is a corporation that liquidates after the sale and before the contingent liability is paid, both the additional amount realized and the deduction apparently disappear. If the amount realized would have been capital or Code section 1231 gain, this is a net disadvantage to Seller. Payment of the contingent liability should not affect Seller's shareholders. If Seller is the old target for which an election under Code section 338 is made, it apparently suffers the worst of all worlds being subject to the additional amount realized, without any offsetting deduction or other allowance, other than a step up in basis to reflect the payment.[95]

i. Effect of Treating Estimated Contingent Liability as Payment at Time of Sale

While the economic-performance regulations were in proposed form, some commentators apparently urged that the deemed-payment rule be applied to contingent liabilities as well as fixed liabilities.[96] If this suggestion, which is conceptually similar to the quotable payment provisions, had been adopted in future regulations, it would have added additional complexity to the area. The amount determined for the contingent liability at the time of the sale must be an estimate. The estimated amount should be the discounted present value of the estimated future payments.[97]

It seems inconceivable that any undiscounted amount could ever satisfy the economic-performance provisions, since they were adopted as a response to the distortion resulting from deduction of undiscounted amounts and deliberately chose to delay deduction rather than permit current deduction of discounted amounts.[98] For similar reasons, it is not likely that the separate regulations referred to in the Preamble will treat a transfer of a contingent liability as a deemed payment. So far, this approach has not been adopted.

There are, however, some contingent liabilities that are not subject to the economic-performance or other deferral provisions, and it is conceivable that the IRS could be persuaded to permit deemed-payment treatment if it were convinced that there would no significant tax avoidance possibilities. If a contingent liability is considered at the time of sale, the major issue is how to account for an eventual payment that is different in amount from the amount estimated at the time of the sale. The most likely approach is to treat the corrected payment as a further adjustment of the price for the purchaser under the principles of the existing regulations under §§

1060 and 338.[99] For the seller, any such adjustment in an installment sale is also an adjustment with the same character as the sale under Code section 453B(a) and the Arrowsmith doctrine.

Example 4: Estimated contingent deductible obligation included at sale subject to adjustment when fixed. Seller owns a business valued at $250,000, and his basis in the business is $200,000. The business sells merchandise backed by a one-year warranty. Purchaser agrees to purchase the business. As part of the sales contract, Purchaser agrees to assume all warranty claims that may arise in the future with respect to any sales that occurred while Seller owned the business. Although the exact cost of the future warranty claims that may arise with respect to sales prior to the transfer is not known, past experience indicates that the cost of the expected warranty claims will total $5,000. Based on this estimate, the amount Purchaser actually pays for the business is reduced to $245,000. After the sale, no warranty claims are made for the remainder of 1994. One year later, Purchaser pays $3,960 for all warranty claims relating to a pre-closing sale. Both Seller and Purchaser use the accrual method of accounting and the calendar year. The short-term AFR is 10 percent annual interest.

If the contingent liability is taken into account for the year of the sale, Seller's amount realized on the sale is $250,000, and Purchaser's basis in the business is also $250,000. Seller can deduct $5,000 as payment of warranty claims because there is a deemed payment at the time of the sale. When $3,960 is paid for the contingent liability one year later, the $3,960 is treated as a separate OID debt instrument, and a portion of the payment must be treated as interest. Therefore, at an AFR of 10 percent annually, $360 is treated as a payment of interest, and the remaining $3,600 is treated as an adjusted payment of purchase price for the business. When payment is made, Purchaser decreases the basis in the business by $1,400 ($5,000 – $3,600) and deducts $360 of interest, subject to any applicable limitations. In the later year, Seller reports $360 of interest income and a loss of $1,400 (the difference between the estimated warranty claim and the principal portion of the settlement payment) on the sale of the business. The loss is characterized in accordance with Code section 453B(a) or Arrowsmith, subject to the application of Code section 1341(a)(5). In addition, and subject to Code section 111, Seller has $1,400 of tax-benefit income for the later year, which represents the excess of the prior warranty deduction over the final net principal amount paid. Thus, Seller realizes $360 of interest income and $1,400 of tax benefit income that may or may not be offset by the $1,400 loss on readjusting the sale price of the business assets.

ii. Effect of Treating Estimated Contingent Liability As Payment at Time of Sale with Subsequent Adjustment as Separate Transaction

Another, somewhat less plausible, approach is to treat the transaction as completely closed at the time of the sale. This parallels the IRS approach in cases where Burnet v. Logan does not apply, where the seller elects out of the installment method,[100] or in cases subject to the OID regulations for quotable payments.[101] Under this approach, any difference between the estimated amount and the final amount paid by the purchaser is accounted for as a separate transaction with separate tax consequences. If the liability is settled for less than the amount estimated, the difference should be discharge of indebtedness income.[102] If it is settled for more, the excess should be a business deduction,[103] but we suspect the IRS would try to treat it as additional purchase price under the principle of the Arrowsmith case.[104] No portion of any subsequent payment on the transferred obligation should be interest under the OID rules because the transfer of the obligation is an assumption that does not give rise to OID.[105] Under a completely closed transaction approach, the final settlement should have no tax effect on the seller because the transaction is fully accounted for at the time of the sale.[106]

Example 5: Estimated contingent deductible obligation included at sale; adjustment when

obligation fixed treated as separate transaction. Seller owns a business valued at $250,000, and his basis in the business is $200,000. The business sells merchandise backed by a one-year warranty. Purchaser agrees to purchase the business. As part of the sales contract, Purchaser agrees to assume all warranty claims that may arise in the future with respect to any sales that occurred while Seller owned the business. Although the exact cost of the future warranty claims that may arise with respect to pre-closing sales is not known, past experience indicates that the expected cost of the warranty claims will total $5,000. Based on this estimate, the amount Purchaser actually pays for the business is reduced to $245,000. No warranty claims are made for the remainder of the year of sale. One year later, Purchaser pays $3,960 in satisfaction of all warranty claims arising out of pre-closing sales. Both Seller and Purchaser use the accrual method of accounting and the calendar year. The short-term AFR is 10 percent annual interest.

If the contingent liability is taken into account for the year of the sale, Seller's amount realized on the sale is $250,000, and Purchaser's basis in the business is also $250,000. Seller is entitled to a deduction equal to the $5,000 deemed payment at the time of the sale. When the contingent liability is paid during the next year, the $3,960 payment is treated as a settlement of a $5,000 liability for $3,960, resulting in discharge of indebtedness income of $1,040. No portion of the $3,960 payment is interest under the OID rules because the obligation is not a debt instrument. The settlement has no further effect on Seller as either additional amount realized or as an adjustment of the deduction claimed.

If Purchaser pays warranty claims of $6,000 one year later, the $1,000 excess should be a business expense or business loss for Purchaser. It is likely that the IRS will assert, however, that the additional payment is purchase price under the principle of the *Arrowsmith* case. Even if Arrowsmith applies to characterize the payment by Purchaser, it should not affect Seller's amount realized or deduction.

iii. Effect of Treating Estimated Contingent Liability As Not Being Payment at Time of Sale with Subsequent Deduction Allowed to Purchaser

Some commentators have suggested that given the uncertainties of valuation and determining which liabilities of a continuing business properly belong to the period prior to the sale, contingent deductible liabilities should be ignored when accounting for the sale transaction and the deduction should be allowed to the purchaser when the obligation becomes fixed. Although these commentators claim a variety of policy advantages for this treatment, including administrative convenience and tax neutrality, they recognize the need for anti-abuse provisions, special treatment of deferred compensation and actively disputed obligations, and, of course, nondeductible treatment for contingent liabilities.[107] Others have raised significant questions about the policy and other justifications for the proposal.[108] The critics have the better of the case and that, except for the valuation difficulty, the policy justifications for the proposal are not sufficient to justify distinguishing deductible contingent liabilities from nondeductible ones. In addition, we note that the proposals were made at a time when there was not a significant capital gains rate preference and there was no amortization deduction for Code section 197 intangibles. Accordingly, the author believes the approach that treats the settlement of a contingent liability as chargeable to the seller is superior. Nevertheless, the following example illustrates the alternative proposal.

> *Example 6: Contingent deductible obligation not considered part of sale; deductible by purchaser when fixed.* Seller owns a business valued at $250,000, and his basis in the business is $200,000. The business sells merchandise backed by a one-year warranty. Purchaser agrees to purchase the business. As part of the sales contract, Purchaser agrees to assume all warranty claims that may arise in the future with respect to any sales that occurred while Seller

owned the business. Although the exact cost of the future warranty claims that may arise with respect to pre-closing sales is not known, past experience indicates that the expected cost of the warranty claims will total $5,000. Based on this estimate, the amount Purchaser actually pays for the business is reduced to $245,000. No warranty claims are made for the remainder of the year of sale. One year later, Purchaser pays $3,960 in settlement of all warranty claims arising out of pre-closing sales. Both Seller and Purchaser use the accrual method of accounting and the calendar year. The short-term AFR is 10 percent annual interest.

Because the contingent liability is not considered as part of the sale, Seller's amount realized is $245,000 and Purchaser's basis in the business is also $245,000. Seller is never entitled to a deduction equal to the price reduction for the warranty risks and never includes anything relating to them in its amount realized. When the contingent liability is paid the next year, the $3,960 amount is deductible by Purchaser. The only accounting for the difference between the estimate and the amount paid is Purchaser's lower basis and reduced deduction. No portion of the $3,960 payment is interest under the OID rules because the obligation is not a debt instrument. If Purchaser pays warranty claims of $6,000 the next year, the entire $6,000 is a deduction for Purchaser. There is no further accounting for the excess over the estimate made at closing.

Part 2 of this article, which will appear in the September issue of The Practical Tax Lawyer, will resume the discussion of contingent liabilities and also examine installment sale implications, tax treatments for profit interests for partnerships and Code Section 1061, and estate planning challenges and opportunities for transfers of earnouts and profit interests in trust.

Notes

1 Chapter one of this outline was previously published in Bloomberg BNA (01/23/2017) and has been reprinted by PLI as part of the written materials for their program on Tax Aspects of Mergers and Acquisitions.

2 If the seller remains associated with the business, an earnout can induce the seller to ensure the continued success of the business.

3 The financial literature discusses earnouts. See Roccili and Fuhr, Jr., The Pros and Cons of Earnouts, Journal of Financial Service Professionals, page 88 (November 2001). The ABA 2004 Annual Meeting, August 7, 2004, presented a program entitled, Earnout in Business Acquisitions: A Practical Solution or A Trap for the Unwary?

4 Commissioner v. Tufts, 461 U.S. 300 (1983), and Treas. Reg. § 1.1001-1(g)(1).

5 Crane v. Commissioner, 331 U.S. 1 (1947).

6 See § 453(b)(2), (f)(2), and (k) describing assets ineligible for classification as an "installment sale."

7 I.R.C. § 453(a) and (c); Temp. Reg. § 15A.453-1(a) and (b)(2)(i).

8 I.R.C. § 453(c); Temp. Reg. § 15A.453-1(b)(2)(iii).

9 Rev. Rul. 68-13, 1968-1 C.B. 195.

10 Rev. Rul. 73-555, 1973-2 C.B. 159 (includes unsecured business liabilities as qualified liabilities). For example, the electric bill for a building.

11 Temp. Reg. § 15A.453-1(b)(2)(iv); Rev. Rul. 76-109, 1976-1 C.B. 125 (brokerage, legal and accounting fees). See also Connors v. Commissioner, 88 T.C. 541 (1987) (similar conclusion under I.R.C. § 1038 relating to repossessions; interestingly, the sellers in that case had correctly included the purchaser's payment of the brokerage fees as a payment in initially reporting the installment sale).

12 Temp. Reg. § 15A.453-1(b)(2)(iv); cf. Reg. § 1.707-5(a)(6) and (7) (similar concept under disguised sale rule for partnerships in that liabilities incurred for capital expenditures or in ordinary course of business are qualified; presumption that liabilities incurred within two years are not qualified). But see Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961) (similar concept for liabilities transferred under § 357(b) in transactions under § 351, but liabilities in question respected by court), payable annually.

13 Temp. Reg. § 15A.453-1(b)(2)(iv); cf. Reg. § 1.263(a)-2(e). The selling commission reduces the sale price, thereby reducing the amount realized.

14 Temp. Reg. § 15A.453-1(b)(3)(i). This result was first adopted in 1929. See Regs. 74, Art 352 (1929) and T.D. 4255, amending Regs. 69, Art 44, VIII-C.B. 165 (1929). It was stated in a 1930 "confidential" IRS training manual to be appropriate to eliminate "the difficulty of ever having to consider the profit element of a collection to be in excess of 100 per cent of such collection." See U.S. Treasury Dept. Bureau of Internal Revenue, Installment Sales Under the Revenue Acts of 1926 and 1928 at 23, reprinted in 126 Internal Revenue Acts of the United States 1906-1950 The Laws, Legislative Histories and Administrative Documents

(B. Reams, Jr., ed. 1979). The manual does not mention the irony that the result of eliminating the stated "difficulty" is to convert what would have been the excess gross profit percentage over the period payments are received into an excess "payment" in the year of sale that increases the gain initially reported.

15 Professional Equities, Inc. v. Commissioner, 89 T.C. 165 (1987), acq. 1988-2 C.B. 1.

16 See Voight v. Commissioner, 68 T.C. 99 (1977), aff'd, 614 F.2d 94 (5th Cir. 1980) (purchaser had option to and did make payments directly to mortgagee and guaranteed mortgage); Goodman v. Commissioner, 74 T.C. 684 (1980) (sale terms provided for payments by purchaser directly to mortgagee).

17 Reg. § 1.1274-5(c).

18 In Commercial Security Bank v. Commissioner, 77 T.C. 145 (1982), the court held that the diminution in consideration received by the seller because the buyer agreeing to pay the seller's "accrued business liabilities" was the equivalent of the seller paying off these liabilities. Therefore, the cash method seller is entitled to deduct an amount equal to the amount of these accrued liabilities. And, the business expense deduction occurs at the time of the sale. In effect, the diminution was the practical equivalent of the buyer paying an amount equal to the transferred liability to the seller and the seller simultaneously using this money to satisfy the liability. Hence, the deduction belongs to the seller, not the buyer. The buyer, per David R. Webb Co. v. Commissioner, 77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983), is not entitled to the deduction for paying the seller's obligation. Instead, the buyer's assumption of this liability results in the amount of the assumed liability being part of the purchase price and thus comprises part of the buyer's basis in the asset purchased. Treas. Reg. §§ 1.461-4(d)(5)(i) and 1.461-4(g)(1)(ii)(c) have adopted the Commercial Security Bank deemed payment principle.

19 Although the authors believe that the tax treatment of contingent liabilities as set forth in this paper is a proper and consistent interpretation of the relevant tax principles and authorities, a number of commentators have questioned whether the law is sufficiently clear and have suggested various legislative proposals and other reforms. The authors will refer to these proposals and how they may differ from the author's analysis as appropriate in this outline. See Ellen H. De Mont, Tax Treatment of Contingent Liabilities: The Need for Reform, 28 U. Richmond L. Rev. 113 (1993) ("De Mont"); Alfred D. Youngwood, The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions, 44 Tax Lawyer 765 (1991) ("Youngwood"); New York State Bar Association, Tax Section, Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions, 49 Tax Notes 883 (1990) (NYSBA Tax Section Report); Charlotte Crane, Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless?, 48 Tax Notes 225 (1990) ("Crane").

20 283 U.S. 404 (1931).

21 Id.

22 See Rev. Rul. 58-402, 1958-2 C.B. 15 (IRS requires valuation of contracts and claims to indefinite amounts "except in rare and extraordinary cases"); Sen. Rep. No. 1000, 96th Cong. 2d Sess. 24 (1980) (in light of extension of installment method to contingent payment sale, "open" transaction, cost-recovery method only in "rare and extraordinary cases"); Temp. Reg. § 15A.453-1(d)(2)(iii) (similar language concerning contingent-payment sales when taxpayer elects not to use installment method). See Daniel S. Goldberg, Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980, 24 Tax Lawyer 605 (1981).

23 Temp. Reg. § 1.338(b)-3T(c) (contingent amount taken into account when it becomes fixed and determinable) and Temp. Reg. § 1.338(b)-3T(j) Example 1 (illustrates adjustment when contingent liability becomes fixed) and Temp. Reg. § 1.1060-1T(f)(1) and Temp. Reg. § 1.1060-1T (g) Example 1 (allocation of settlement of a lawsuit); Albany Car Wheel Co. v. Commissioner, 40 T. C. 831 (1964) (contingent liability not included in basis at least until paid); David R. Webb Co. Commissioner, 708 F. 2d 1254 (7th Cir. 1983) (purchaser cannot deduct when paid deferred compensation accrued prior to sale because it is part of price; basis increased only when paid); Gibson Products Co. v. United States, 637 F.2d 1041, 1047-48 (5th Cir. 1981) (no basis as long as liability is uncertain); Zappo v. Commissioner, 81 T.C. 77 (1983) (contingent obligation on guarantee to purchaser not offset against liabilities transferred on sale). For a more detailed analysis of these and similar cases, see De Mont, supra note 19, at 127-31; Youngwood, supra note 19, at 767-78; NYSBA Tax Section Report, supra note 19, at 886-91.

24 See T.D. 8072, 51 Fed. Reg. 3583 (Jan. 29, 1986), 1986-1 C.B. 111.

25 General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935); I.R.C. §§ 311(a), 336(a) prior to amendment by the Tax Reform Act of 1986, P.L. 99-514. Nevertheless, many types of gain were recognized, including LIFO inventories, former I.R.C. §§ 336(b) and 337(f); investment tax credit recapture, I.R.C. § 47(a) and (b); depreciation and similar recaptures, I.R.C. §§ 1245(b) and 1250(d); tax-benefit items, Hillsboro National Bank v. Commissioner, 457 U.S. 1103 (1983); assignment-of-income items, Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948); United States v. Lynch, 192 F.2d 718 (9th Cir. 1952); cash-method receivables, Midland-Ross Corp. v. United States, 485 F.2d 110 (6th Cir. 1973); sale of inventory, Bush Bros. & Co. v. Commissioner, 668 F.2d 252 (6th Cir. 1982); and disposition of installment obligations, I.R.C. § 453B.

26 See Temp. Reg. § 15A.453-1(d)(2)(iii) (requiring immediate recognition by seller in contingent deferred payment sales when cash method seller elects out of the installment method); Rev. Rul. 58-402, supra note 22 (dealing primarily with recognition of gain in corporate liquidations at a time when General Utilities principle provided nonrecognition for most gains to the liquidating corporation).

27 It is possible that an obligation fully enforceable under local law may not be treated as a liability for federal income tax purposes because it is a "contingent liability" in the tax sense.

28 Commercial Security Bank, Inc. v. Commissioner, 77 T.C. 145 (1981). See James M. Pierce Corp. v. Commissioner,

260 F.2d 663 (8th Cir. 1958) (result like that subsequently reached in Commercial Security for transfer of prepaid subscription income).

29 This factor was cited by the NYSBA Tax Section Report, supra note 19, in suggesting that the transfer of the liability should be ignored by the seller, with the purchaser succeeding to the seller's right to the deduction.

30 The Preamble to the economic-performance regulations (including Treas. Reg. § 1.461-4(d)(5)) notes that the Commissioner did not accept the suggestion that the deemed payment rule apply to contingent liabilities and that contingent liabilities should be covered by a separate regulation. T.D. 8408, 1992-1 C.B. 159, 161 (April 10, 1992).

31 See Burnet v. Logan, supra note 20 (refuses to value contingent rights for purposes of determining gain even though similar rights had been valued for estate tax purposes in the estate of the taxpayer's mother).

32 Crane, supra note 19, questions this result because the delay in recognizing the transfer of the contingent liability, when the price has been reduced to reflect it, affects neutrality.

33 See Albany Car Wheel Co. v. Commissioner, supra note 23; David R. Webb Co. v. Commissioner, supra note 18.

34 Taking contingent liabilities into account at the time of sale or exchange would create complex computational problems if the actual amount differed from the estimated amount.

35 As will be discussed, this is more a function of the fact that the OID and installment sale rules for contingent liabilities are not well-known.

36 Cf. Treas. Reg. § 1.752-2(b)(4) (partner's share of liability reduced to the extent of reimbursement rights).

37 Treas. Reg. § 1.1275-4(c)(4)(i). See also Treas. Reg. § 1.483-4(a). Although the contingent payment regulations were initially proposed with the other original issue discount regulations, see Notice of Proposed Rulemaking, 1986-1 C.B. 820, they subsequently became divorced from the balance of the OID regulations, see Notice of Proposed Rulemaking, 1991-1 C.B. 834. Only Prop. Reg. § 1.1275-4 was preserved when the rest of the OID regulations were finalized. T.D. 8517, 1994-1 C.B. 38; see also Notice of Proposed Rulemaking, 1993-1 C.B. 734, 735 (reserving Prop. Reg. § 1.1275-4). A revised version of these controversial regulations was proposed Dec. 16, 1994 and was adopted in final form on June 11, 1996. Treas. Reg. §§ 1.483-4(c) and 1.1275-4, T.D. 8674, effective August 13, 1996. See also Albany Car Wheel Co. v. Commissioner, supra note 23; David R. Webb Co. v. Commissioner, supra note 18.

38 See Youngwood, supra note 19, at 771-72 (noting that imputed interest issued had been ignored by the authorities).

39 Treas. Reg. § 1.1275-4(c). See Kleinbard, Borisky and Vemireddy, Proposed Regulations Affecting Contingent Payment Debt Obligations, 66 Tax Notes 723 (1995). See also Willens, Roadmap Through Contingent Payment Regulations, 66 Tax Notes 109 (1995).

40 Treas. Reg. § 1.1275-4(c)(2).

41 See Kleinbard, Borisky and Vemireddy, supra note 39, at 724-25.

42 See, e.g., Albany Car Wheel Co. v. Commissioner, supra note 33; David R. Webb Co. v. Commissioner, supra note 18.

43 Even for other types of payments, in the absence of well-developed rules, taxpayers who follow the regulations or who have followed any of the prior proposed regulations have a reasonable argument that their position is in accord with common law, particularly in cases in which the IRS's approach has been to limit the application of Burnet v. Logan supra note 20.

44 See Youngwood, supra note 19, properly concluding that I.R.C. § 1274(c)(4) if there is no OID upon assumption of fixed liabilities, should not apply to a transfer of a contingent liability because it is additional purchase price subject to the normal rules.

45 Treas. Reg. §§ 1.1275-4(c)(4) and 1.483-4(a).

46 Treas. Reg. § 1.1275-4(c)(4)(iii).

47 Treas. Reg. §§ 1.1275-4(c)(4) and 1.1275-4(c)(7) Example 1(iv) and 1.483-4(b) Example (1)(iii). See Jerome M. Hesch and Elliott Manning, Family Deferred Payment Sales: Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas, 26 Philip E. Heckerling Univ. of Miami Inst. on Est. Plan. Ch. 3, ¶¶ 303.4 and 309.4.

48 See infra text at notes 63-64.

49 The earlier proposed regulations, Prop. Reg. § 1.1275-4(d)(2) (1991), recognized the inconsistency, but they did not explain it or justify it. The current regulation appears to be silent on this issue.

50 Treas. Reg. §§ 1.1275-4(c)(3) and 1.1275-4(b).

51 Treas. Reg. § 1.1275-4(b)(6)(ii).

52 Treas. Reg. §§ 1.1275-4(b)(6)(iii)(A) and 1.1275-4(b)(7)(vi) Example 1(ii).

53 Treas. Reg. §§ 1.1275-4(b)(6)(iii)(B) and 1.1275-4(b)(7)(vi) Example 1(iii).

54 Treas. Reg. §§ 1.1275-4(b)(6)(iii)(C)(1) and 1.1275-4(b)(7)(vi) Example 1(iii).

55 Treas. Reg. §§ 1.1275-4(b)(6)(iii)(C)(2) and 1.1275-4(b)(7)(vi) Example 2; Kleinbard, Borisky and Vemireddy, supra note 39, at 730.

56 I.R.C. § 453B(f) which provides that any portion of the seller's note that is cancelled results in treating the cancelled principal amount as an additional payment of principal at the time of cancellation.

57 David R. Webb Co. v. Commissioner, supra note 18 (basis increase for deferred compensation accrued prior to sale allowed only when paid).

58 Reg. § 1.1275-4(b)(1).

59 Temp. Reg. § 15A.453-1(d)(2)(iii); Under prior law, the selling price had to be fixed and determined in order to be eligible for installment reporting. In re Steen v. Commissioner, 509 F.2d 1398 (9th Cir. 1975). The NYSBA Tax Section Report, supra note 19, at 892, questions whether payment of a contingent liability, if attributed to the seller, qualifies under the installment method.

60 See I.R.C. § 453(b)(2) (excluding inventory and dealer sales other than farm property, time-shares, and unimproved residential lots identified in I.R.C. § 453(1)(2)), §453 (i) (excluding recapture income); I.R.C. § 453(k) (excluding

publicly traded property) and I.R.C. § 453(f)(2) (effectively excluding purchaser demand notes and readily tradable obligations); I.R.C. § 453(f)(3) and (4) (effectively excluding sales for demand notes or readily tradable obligations).

61 For example, a contingent payment may expressly include a price based on a percentage of future profits.

62 Temp. Reg. § 15A.453-1(c).

63 See text at notes 130-134.

64 Temp. Reg. § 15A.453-1(c)(2).

65 Temp. Reg. § 15A.453-1(c)(2)(iii) Example 8.

66 Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (loss to shareholders on payment of corporate liabilities after liquidation is capital because gain on liquidation was capital gain); see Rev. Rul. 78-25, 1978-1 C.B. 70 (loss in case like Arrowsmith case eligible for I.R.C. § 1341); Rev. Rul. 67-331, 1967-2 C.B. 290 (similar result for repayment of part of I.R.C. § 1231 gain; loss characterized as capital loss not as I.R.C. § 1231 loss because prior net I.R.C. § 1231 was capital gain).

67 See Rev. Rul. 78-25, supra note 66; Rev. Rul. 67-331, supra note 66; see also former Treas. Reg. § 1.483-1(e)(3) Example (4), (under the former provisions of I.R.C. § 483), which provides a "loss in accordance with the other applicable provisions of the Code" without stating what they are or the time or character of the loss.

68 Temp. Reg. § 15A.453-1(c)(3).

69 Temp. Reg. § 15A.453-1(c)(4).

70 Id.

71 See Temp. Regs. §15A.453-1(c)(2)(i), (c)(3)(i), (c)(4) and (c)(7); (allow use of other methods to prevent substantial acceleration or deferral of basis recovery).

72 See, e.g., Priv. Ltr. Rul. 90-13-014 (allows use of estimated contingent payments in computing basis recovery when there are both fixed and contingent payments); Priv. Ltr. Rul. 89-46-028 (same result where estimated that two-thirds of price received in year of sale). See also Priv. Ltr. Ruls. 96-47-035, 96-38-018, 95-44-020, 93-09-016, 92-47-010, 92-21-008, 91-30-004, 89-49-018, 89-32-068, 88-44-063, 88-12-064, 88-05-051, 87-28-026.

73 See Temp. Regs. § 15A.453-1(c)(2)(i), (c)(3)(i), (c)(4) and (c)(7) (allowing use of other methods to prevent substantial acceleration or deferral of basis recovery).

74 Treas. Reg. §§ 1.483-4(a) and 1.1275-4(c)(ii)(A). If the terms of the sale provide for interest payable, at least annually, at the time of a principal payment at a fixed or qualified variable rate more than the AFR, there is technically no OID or unstated interest. Treas. Reg. §1.1273-1(b) and (c); Cf. Temp. Regs. § 15A.453-1(c) Example 4 (providing a payment recharacterization provision to avoid the penalty interest rate under I.R.C. § 483 prior to amendment by the Tax Reform Act of 1984).

75 Temp. Reg. §§ 1.1060-1T(f) and 1.338-3T(c).

76 Temp. Reg. § 1.1060-1T(f)(4).

77 Temp. Reg. § 1.1060-1T(d)(2) and (f)(2) and (3). The NYSBA Tax Section Report recommendation that the deduction for contingent liabilities be allowed for the purchaser is based, in part, on an argument that any price increase for contingent liabilities is not properly considered goodwill or going concern value. NYSBA Tax Section Report, supra note 19, at 892. It should be noted that the Report was issued before the adoption of I.R.C. § 197.

78 Christian M. McBurney and George L. Middleton, Jr., 15-Year Amortization May Hold Opportunities for Realty-Related Intangibles, 81 J. Tax. 94 (Aug. 1994).

79 See H.R. Rep. No. 213, 103d Cong. 2d Sess. 1993-3 231-32 (1993).

80 The regulations are consistent with the principles of the Albany Car Wheel Co. and David R. Webb. Co. cases, supra notes 33 and 57.

81 Temp. Reg. § 1.1060-1T.

82 See Youngwood, supra note 19, at 784 (discussing incentive of parties to overvalue); NYSBA Tax Section Report supra note 19, at 893-94 (discussing valuation difficulties).

83 Supra note 18.

84 See Temp. Reg. § 1.338(b)-3T(c) (contingent amount taken into account when it becomes fixed and determinable) and (j) Example 1 (illustrates adjustment when contingent liability becomes fixed) and Reg. § 1.1060-1T(f)(1) and (g) Example 1 (allocation of settlement of a lawsuit).

85 See Tech. Adv. Mem. 89-39-002 (applies Commercial Security to accrued but unpaid extra compensation, allowing a deduction for the deemed-paid amount, but postpones deduction for deferred compensation from time of sale until allowable under I.R.C. § 404(a)(5)); but see Fisher Companies, Inc. v. Commissioner, 84 T.C. 1314 (1985), aff'd in unpub. op., 806 F.2d 263 (9th Cir. 1986) (seller required to include cost of roof repair in amount realized; did not argue for deduction until too late on appeal).

86 See Youngwood, supra note 19, at 779-82, NYSBA Tax Section Report, supra note 19, at 893-94; Carman and Fortini-Campbell, The Assumption of Contingent or Cash Method Liabilities—Can It Result in Deductible Expenditures in the Assuming Partnership, 10 J. Part. Tax. 361, 363 (1994).

87 Compare Treas. Reg. § 1.164-6 (dealing with allocation of real estate taxes).

88 See, e.g., Temp. Regs. § 1.338(b)-3T(c), (d), (e) and (j) Example 1 (adjustments for "new" target after I.R.C. § 338 election).

89 See Youngwood, supra note 19, at 769-70.

90 See Tech. Adv. Mem. 87-41-001 modified by Tech. Adv. Mem. 91-25-001 (initially denied deduction to seller for warranty costs to "old target" in I.R.C. § 338 transaction because it is no longer in existence but modified ruling concludes that Temp. Reg. § 1.338(b)-3T keeps old target alive for purposes of reporting both the additional amount realized and the related deduction); cf. Beauty Acquisition Corp. v. Commissioner, 69 TCM 1971 (1995) (liquidating corporation not taxable on contingent claim pending at time of liquidation because disputed claim does not accrue until dispute is resolved; decided under I.R.C. § 336 prior to 1986 amendment); Shea Co. v. Commissioner, 53 T.C. 135 (1969) (same re corporate taxation; rejects ordinary income taxation for shareholders; shareholders realize capital gain on receipt of proceeds; IRS argument that claim should be valued at time of liquidation rejected for lack of evidence of value).

91 Supra note 66, above.

92 See Manning and Hesch, Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Three), 11 Tax Management Real Estate Journal 51 (1995).

93 David Webb Co. v. Commissioner, supra note 18.

94 Cf. Commercial Security Bank v. Commissioner, supra note 18Error! Bookmark not defined.; Commissioner v. Allan, 86 T.C. 655 (1986), aff'd, 856 F.2d 1169 (8th Cir. 1988) (portion of balance of nonrecourse mortgage representing taxes and interest paid by mortgagee and added to principal is amount realized on foreclosure, not a recovery of the prior deduction that is tax-benefit income).

95 Treas. Regs. § 1.338(b)-3T(c), § 1.338(b)-3T(d), § 1.338(b)-3T(e), and § 1.338(b)-3T(j) Example 1.

96 See Preamble, supra note 30. The approach of valuing contingent liabilities at sale is recommended for the seller by De Mont, supra note 19, at 140, although she continues to treat the purchaser as described above, id. at 141; it was considered and rejected by Youngwood, supra note 19, at 783-84 and by the NYSBA Tax Section Report, supra note 19, at 898. None of them consider the effect of a subsequent settlement at a different amount.

97 See Ford Motor Co. v. Commissioner, 102 T.C. 87 (1994) aff'd, 71 F.2d 209 (6th Cir. 1995), (requires discounting of tort claims settlements; applies to years prior to the effective date of the economic-performance provisions). Some earlier, pre-§ 461(h), cases had allowed accrual of the full amount of the claim without discounting, see, e.g., Kaiser Steel Corp. v. United States, 717 F.2d 1304 (9th Cir. 1983); Burnham Corp. v. Commissioner, 90 T.C. 953, 960 (1988) aff'd, 878 F.2d 86 (2d Cir. 1989). But cf. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969) (deduction disallowed even though payment was certain when time of payment was uncertain and likely to be long delayed).

98 See Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 258-61.

99 Treas Regs. § 1.338(b)-3T(c), § 1.1060-1T(f)(1), and § 1.1060-1T(g) Example 1.

100 See Temp. Reg. § 15A.453-1(d)(2)(iii); Rev. Rul. 58-402, 1958-2 C.B. 15; Osenbach v. Commissioner, 17 T.C. 797 (1951), aff'd, 198 F.2d 235 (4th Cir. 1952) (collection of receivables with a basis less than face received in liquidation under former I.R.C. § 333 is ordinary income, not capital gain, under Arrowsmith as part of liquidation); Garrow v. Commissioner, 43 T.C. 890 (1965) (same).

101 Treas. Regs. § 1.1275-4(b)(6), § 1.1275-4(b)(7)(v), and § 1.1275-4(b)(7)(vi) Example 3 (loss on retirement of obligation with adjusted basis in excess of amount collected is treated as loss on retirement of instrument).

102 See, e.g., Rev. Rul. 77-437, 1977-2 C.B. 28 (issuer has discharge-of-indebtedness income when retires low-interest bonds by exchanging new bonds with a higher interest rate but a lower principal amount); Rev. Rul. 82-202, 1982-2 C.B. 35 (homeowner has discharge of indebtedness income when accepts bank invitation to pay off low interest mortgage at a discount); Sutphin v. United States, 14 Ct. Cl. 545 (1988) (same); Aizawa v. Commissioner, 99 T.C. 197 (1992) aff'd, 29 F.3d 630 (9th Cir. 1994), (borrower subject to deficiency judgment will have to account in future if discharged for less than amount borrowed); Frazier v. Commissioner, 111 T.C. 243 (1998) (same); cf., United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991) (S&L has ordinary income from penalty, not discharge-of-indebtedness income, when accrued interest reduced as a result of early withdrawal); Rev. Rul. 84-176, 1984-2 C.B. 91 (reduction in amount owed for goods to settle claim for failure to deliver other goods was contract damages not discharge-of-indebtedness income).

103 See Treas. Reg. § 1.163-3(c) (deduction for premium paid to retire bond); Priv. Let. Rul. 94-38-001 (treats amount paid to retire stock appreciation rights and stock options as compensation paid by target) but cf., Priv. Let. Rul. 92-06-004 (treats retirement of lender warrants in connection with I.R.C. § 338 acquisition as closing transaction under I.R.C. § 1234(b)(1), not as business expense).

104 Supra note 66. Cf., Treas. Reg. § 1.1060-1T(g) Example 2(v) (character of loss resulting from subsequent reduction in price allocated to an asset after the asset has been disposed of is determined under Arrowsmith).

105 I.R.C. § 1274(c)(4); Treas. Reg. § 1.1274-5 (OID on assumptions only if modification). Cf. I.R.C. § 1273(b)(5) (property includes services and the right to use property); but cf. Reg. § 1.1274-1(a) (property for purposes of AFR rules does not include money, services or the right to use property). The effect of these seemingly inconsistent rules is that accruals seem to be covered by I.R.C. § 1273 dealing primarily with publicly traded debt issued for property (or debt issued for publicly traded property, which can hardly include accruals) or by the residual rule that the issue price of an obligation is face, but never by I.R.C. § 1274 requiring use of the AFR. This issue is discussed in Sheppard, The Ninth Circuit Creates a New Interest Deduction, 62 Tax Notes 405 (1994).

106 See Youngwood, supra note 19, at 783, NYSBA Tax Section Report, supra note 19 at 898.

107 See Youngwood, supra note 19, at 784-85; NYSBA Tax Section Report, supra note 19, at 891-97.

108 See De Mont, supra note 19, at 138-40; Crane, supra note 19.