Tax Accounting

BY JAMES E. SALLES

This month's column discusses the Tax Court's recent decision in *Illinois Tool Works, Inc. v. Commissioner*,[1] requiring capitalization of a contingent liability assumed in purchasing a business.

LATENT LIABILITIES

The debt that a buyer incurs or assumes in acquiring an asset is ordinarily part of its cost and thus its tax basis. This sometimes leads to questions about whether particular liabilities were assumed at the time of acquisition or whether they independently arose afterwards. While this problem commonly arises in the context of the acquisition of an ongoing business, these kinds of latent liabilities can exist as to individual assets as well. Moreover, although I generally refer below to the parties as "buyer" and "seller," the same issues can arise in taxable exchanges, "deemed sales," following an election under Code Section 338, and some tax-free transactions—in any setting where a preexisting liability is assumed in connection with the transfer of property, and the transferee is not treated as the continuation of the transferor for tax purposes.

Apart from liabilities of cash-basis transferors in certain tax-free transactions,[2] and liabilities to perform under prepaid contracts where the associated income is reported by the buyer,[3] a buyer that assumes the seller's liability adds it to the basis of the property acquired. Precisely when this happens is sometimes a question, and the law is also not entirely clear as to when the seller takes into account its additional amount realized, and whether and when it gets an ordinary deduction as opposed to merely an offset to gain,[4] but those are topics for another day. So far as the buyer's obligation to capitalize is concerned, the key question is whether the liability "belongs" to the buyer or the seller.

Jim Salles is a member of Caplin & Drysdale in Washington, D.C.

Fixed Liabilities

The traditional "all events" test allowed accrual taxpayers deductions when "all events have occurred, which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy."[5] The law has long been fairly clear that a liability that meets this standard at the time of the sale is a liability of the seller. The Supreme Court so held long ago as to real estate taxes in *Magruder v. Supplee*.[6] Traditional "all events" principles produce somewhat arbitrary results as applied to real estate taxes, and Code Section 164(d) now provides specific rules for allocating the liability between buyer and seller. However, the basic rule of *Supplee* still applies: to the extent that a buyer pays taxes that are allocated to the seller under these rules, the payment adds to property basis. The same thing happens when the buyer agrees to pay interest that accrued before the sale.[7]

Fixed Liabilities Producing Deferred Deductions

Sometimes a liability meets the "all events" test but the deduction is deferred under some other provision, such as Section 404, which generally allows a deduction for nonqualified deferred compensation only when paid.[8] The 1984 addition of the requirement that "economic performance" occur before a deduction is allowable might have greatly expanded the category of "deferred" liabilities meeting the basic "all events" test, but the regulations sensibly provide that if a business is sold, economic performance occurs as to any assumed liability when the seller recognizes the additional "amount realized" from the assumption.[9]

The courts have consistently classified such liabilities as belonging to the seller even if no deduction is allowable at the time of sale. In holding that, the buyer could not include deferred compensation liabilities in property basis until the Section 404 standard was met. The Seventh Circuit stated in *F&D Rentals v. Commissioner*[10]

that "[u]nder § 404(a) of the Code, taxpayer would have been entitled to a pension plan deduction if it had made a payment in the taxable year." However, the buyer in *F&D Rentals* was arguing for immediate *basis*, not a deduction. When the deduction issue came before the same circuit in *David R. Webb Co. v. Commissioner*,[11] the court made clear that its earlier observation concerning deductions was dicta and not part of the holding.

So far as the buyer's obligation to capitalize is concerned, the key question is whether the liability "belongs" to the buyer or the seller.

Webb involved a company's promise to pay a lifetime pension to a worker's widow if he died while in its employ. The employee died, and payments under the contract began. Twenty years (and three changes of ownership) later, management sought to take a current deduction. The court held that the obligation was part of the cost of acquisition, and the payments would be added to basis at the time that they otherwise would be deductible under Section 404.[12]

Contingent Liabilities

The law has been somewhat murkier as to liabilities that remain contingent at the time of sale, but the sparse authorities are generally consistent with the notion that liabilities that are in existence — even though contingent and thus not meeting the "all events" standard — at the time of the sale, are nonetheless treated as the seller's liabilities when they have to be taken into account. In *Holdcroft Transportation Co. v. Commissioner*[13] for example, the court held that payments of a judgment on a suit that was pending at the time of the transaction were capital to the buyer because the tort liability "accrued" — under general legal principles although not in the technical "all events" sense — at the time of the incident.[14]

Liabilities Arising Post-Sale

A different rule applies, however, if the liability is *not in existence at all* at the time of the sale, even though it in some sense relates to the pre-sale period. The leading case is *United States v. Minneapolis & St. Louis Railway Co.*[15] The taxpayer in *Minneapolis & St. Louis* acquired the assets of a corporation in receivership and thereafter agreed to a union contract providing for a retroactive wage increase that in part related to the period before the transfer. Distinguishing *Holdcroft*, the court allowed the taxpayer a deduction, reasoning that the liability did not belong to the predecessor corporation, which was not a party to the new contract and had never been obliged to pay the extra wages.

Probably the most sophisticated IRS analysis of the issue appears in a 1984 general counsel memorandum[16] that examined whether an obligation to make payments to a pension plan under the "minimum funding" rules that arose *after* the sale but related to "past-service cost" — that is, to services performed before the sale —was a liability of the seller or the buyer. The memorandum held that the buyer would have to capitalize (1) any liability to the Pension Benefit Guaranty Corporation and/or participants that would have existed if the plan had been terminated upon the sale, and (2) any payments required under the "minimum funding" rules as of the time of the sale. However, minimum funding obligations that arose as a result of continuing the pension plan after the sale — even though they related to services performed before the sale — were obligations of the buyer and could be deducted under normal timing rules.

ILLINOIS TOOL

The Tax Court's decision in *Illinois Tool* reinforces the presumption in favor of capitalizing contingent liabilities.

The Case

The taxpayer in *Illinois Tool* was hit by some of the fallout from the extensive patent litigation initiated by inventor Jerome H. Lemelson. The taxpayer bought certain assets of the DeVilbiss Co., a former division of Champion Spark Plug Co., subject to a pending patent

claim by Lemelson, which the parties had valued at $400,000 for purposes of setting up a reserve. (The seller's predecessor had rejected a $500,000 settlement offer by Lemelson.) As matters turned out, however, the taxpayer lost the suit, and the appeal, and wound up having to pay over $17 million.

The Tax Court's decision reinforces what appears to be a growing consensus that, timing issues aside, contingent liabilities ought to be treated like any other liabilities assumed in connection with an acquisition and capitalized into basis.

The taxpayer capitalized $1 million of the amount paid, and sought to deduct the rest. Its rationale was that $1 million represented the approximate amount of the liability that the parties had contemplated in setting the price, while the remaining liability was completely unanticipated and could not have affected the terms of the deal. However, the court held that, such considerations aside, the liability was in existence at the time of the acquisition, and had to be capitalized into the basis of the property acquired. The taxpayer also cited *Nahey v. Commissioner,*[17] which held that a *recovery* in a pending lawsuit represented ordinary income to the buyer to the extent that it would have done so to the seller, in favor of its right to deduct a liability in similar circumstances. But the court held that the *Nahey* doctrine was irrelevant to liabilities "in light of the consistently applied rule that payment of liabilities incurred as part of an acquisition must be capitalized."

Outlook

The Tax Court's decision reinforces what appears to be a growing consensus that, timing issues aside, contingent liabilities ought to be treated like any other liabilities assumed in connection with an acquisition and capitalized into basis. Some commentators have suggested that capitalization might not be required as to liabilities that were unknown and unknowable at the time of the sale.[18] However, the court's reasoning, building on such earlier cases as *Holdcroft*, would appear to rule out such an argument. While the court did note that the parties had considered, and the taxpayer had expressly assumed, the Lemelson liability, it also observed that the logic of *Webb* compelled capitalization "whether or not such obligation was fixed, contingent, or even known at the time such property was acquired."

The taxpayer's theory that it could deduct a liability to the extent it was "unexpected at the time of purchase" was essentially an economic argument rather than a legal one. The court' s rejection of it is logically consistent with, for example, the recent case of *United Dairy Farmers, Inc. v. United States*,[19] requiring a buyer to capitalize the cost of remedying preexisting environmental contamination, even though the taxpayer in that case also argued that the costs were "unexpected" and had not been taken into account in setting the purchase price.

On the other hand, the court's decision appears to leave intact the authorities following *Minneapolis & St. Paul* that hold that if a liability truly arises after the transaction, even though based upon events that have occurred before, then the deduction belongs to the buyer. For example, if the taxpayer in *Illinois Tool* had not been potentially liable to Lemelson at the time of acquisition but had later agreed, for example in a license agreement, to pay a "retroactive" royalty covering the period before the sale, its liability under the contract would probably have been deductible under normal rules.

1. 117 T.C. No. 4 (July 31, 2001).

2. *E.g.*, Rev. Rul. 80-198, 1980-2 C.B. 113; *see also, e.g.*, Gen. Couns. Mem. 39054 (11/24/81).

3. *See, e.g.*, PLR 8612050 (12/23/85) holding (5) (cost of meeting existing subscription obligations deductible when buyer includes the corresponding prepayments in income under James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964) and Rev. Rul. 71-450, 1971-2 C.B. 78); *compare, e.g.*, Rev. Rul. 76-520, 1976-2 C.B. 42 (similar costs capital to transferee in tax-free transaction where it did not recognize income).

4. *See, e.g.*, Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981) (cash basis bank's liability for accrued interest); PLR 8641001 (6/16/87), *modified by* PLR 9125001 (6/21/91) (warranty liability); PLR 8939002 (9/29/89) (unpaid deferred compensation); see generally, e.g., New York State Bar Ass'n, "Report on the Federal Income Tax Treatment of Contingent Liaibilities in Taxable Asset Acquisition Transactions," 49 Tax Notes 883 (1990).

5. I.R.C. 461(h)(4); Reg. 1.461-1(a)(2)

6. 316 U.S. 394 (1942).

7. *See, e.g.*, Rodney, Inc. v. Commissioner, 2 T.C. 1020 (1943), *aff'd*, 145 F.2d 692 (2d Cir. 1944) (taxpayer could not deduct its former subsidiary's interest obligation that it had assumed in a tax-free liquidation).

8. *See* I.R.C. 404(a)(5) (deduction allowed when the year in which the recipient recognizes income closes).

9. Reg. 1.461-4(d)(5).

10. 365 F.2d 34, 41 (7th Cir. 1966), *cert. denied,* 385 U.S. 1004 (1967).

11. 708 F.2d 1254 (7th Cir. 1982).

12. *Accord*, e.g., M. Buten & Sons v. Commissioner, 31 T.C.M. (CCH) 178 (1972); *see also* PLR 8939002 (9/29/82), allowing the seller a deduction but only when the amount was paid.

13. 153 F.2d 323 (8th Cir. 1946).

14. *Accord,* e.g., Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974) (similar facts and holding); *see also*, *e.g.*, United States v. Smith, 418 F.2d 589, 596 (5th Cir. 1969) (corporation's payment of ex-partner's claim against predecessor partnership would be capital if found to have been assumed in connection with the transfer of property upon incorporation); LTR 8741001 (6/16/87) (treating a pre-existing warranty obligation as a seller's obligation for purposes of allowing a deduction).

15. 260 F.2d 663 (8th Cir. 1958).

16. Gen. Couns. Mem. 39274 (4/23/84).

17. 196 F.3d 866 (7th Cir. 1999), *aff'g* 111 T.C. 256 (1998).

18. See, e.g. Kevin M. Keyes, "The Treatment of Liabilities in Taxable Asset Acquisitions," 50 N.Y.U. Inst. § 21.04[1][c] at 21-23 (1992).

19. 107 F. Supp. 2d 937 (S.D. Oh. 2000), *aff'd,* 2001 WL 1159612 (Oct. 3, 2001), previously discussed in J. Salles, "Tax Accounting," 1(12) Corporate Business Tax'n Monthly 25, 26 (Sept. 2000).