

REPORT #787

TAX SECTION

New York State Bar Association

Business Plan: Assumption of Contingent Liabilities
in Asset Acquisitions

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April 22, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Business Plan: Assumption of Contingent
Liabilities in Asset Acquisitions

Dear Secretary Samuels and Commissioner
Richardson:

I am writing to urge that prompt guidance be-provided to taxpayers on issues relating to the assumption of contingent liabilities in asset acquisitions.

Both taxable and nontaxable acquisitions of the assets of a business have increasingly involved the assumption by the transferee of contingent liabilities of the transferor. Contingent liabilities commonly assumed in such acquisitions include liabilities for retiree medical benefits, environmental and

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tort liabilities, and deferred compensation liabilities. Even in the case of an accrual basis transferor, these liabilities may not give rise to a deduction to the transferor prior to the time of the acquisition because, for example, (i) the all events test is not yet satisfied (e.g., in the case of a contested liability), (ii) section 461(h) defers the deduction until payment is made (e.g., in the case of a tort liability) or (iii) some other provision of the Internal Revenue Code defers the deduction until a later date (e.g., section 404(a)(5)/ in the case of nonqualified deferred compensation).

The tax treatment of the assumption and subsequent payment of contingent liabilities in taxable asset acquisitions is an area of significant uncertainty and promises to be a source of costly litigation between taxpayers and the government. Guidance is needed, especially on the issue of the deductibility of amounts ultimately paid by the transferee. On November 1, 1990, the Tax Section submitted its "Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions" (published at 49 Tax Notes 883 (November 19, 1990)) to the Treasury Department and to the Internal Revenue Service in the hope that this important and difficult subject might be addressed in regulations or rulings. While the Report made certain specific recommendations, its main purpose was to stimulate discussion of the issues in this area so that appropriate guidance could be promptly developed. For this reason, we were extremely disappointed that the regulations project on this subject (IA-REG-012-93) was closed on January 11, 1994 without the issuance of regulations. We believe it is critical that the Service either reinstate this regulations project or issue a series of published rulings dealing with the assumption of contingent liabilities.

One particular subject on which the Service could promptly issue a published ruling is the assumption of contingent liabilities in section 351 transactions. As we stated in our

Report (at pp. 32-35), we believe that the transferee corporation in a section 351 transaction should be permitted to deduct assumed contingent liabilities to the extent such liabilities would have been deductible by the transferor. On July 16, 1993, the Service issued a private letter ruling (PLR 9343011), which appears to agree with our recommendation.

The letter ruling involved the transfer of assets of a business and the assumption by the transferee of "Q" and "R" liabilities which, we understand, represent post-employment benefits (other than pension liabilities) and environmental claims which the transferor had not yet been entitled to deduct under sections 404(a)(5), 404(b) and 461(h). Both the transferor and the transferee were on the accrual method of accounting. The Service concluded that the "Q" and "R" liabilities were excluded under section 357(c)(3) in determining the transferor's gain since they would give rise to a deduction when paid. More importantly, the Service also concluded that the "Q" and "R" liabilities would be "deductible by the Transferee in accordance with the provisions of sections 162, 404(a)(5), 404(b) and 461(h) of the Code to the extent that such liabilities would have been deductible by [the transferor] had they not been transferred to Transferee."

In reaching this conclusion, the Service expanded upon its published rulings involving the assumption of deductible liabilities in connection with the incorporation of cash basis businesses. In Rev. Rul. 80-198, 1980-2 C.B. 113, the Service allowed a cash basis corporation to deduct payments of the accounts payable of a sole proprietorship that it assumed in a section 351 transaction. In Rev. Rul. 83-155, 1983-2 C.B. 38, deductions were allowed to a cash basis corporation for payments of liabilities to retired partners that would have been treated as guaranteed payments under section 736(a)(2) and that were assumed upon the incorporation of the partnership.

The Service expressed three bases for its published rulings in G.C.M. 39054 (November 7, 1983). First, since the incorporated business was required to include in income payments on the transferred accounts receivable, the failure to allow a deduction for corresponding payables (including the guaranteed payments in Rev. Rul. 83-155) would distort income. Second, since the transferee in a section 351 transaction is not allowed any basis increase with respect to the assumed liability, the failure to allow a deduction would result in the transferee never being able to recover the cost of the assumed amounts.¹ Third, congressional policy favors the elimination of impediments to business readjustments. As the Service stated in Rev. Rul. 83-155:

"The taxpayer is making the same payments that the partnership was making. The payments would have been deductible by the partnership had the partnership continued in existence. The congressional intent to facilitate necessary business readjustments would be frustrated by not according to the

¹ The transferee's basis in its assets in a section 351 transaction is determined under section 362(a) and is equal to the basis of the transferor, increased by any gain recognized by the transferor on the exchange. Assumed liabilities do not increase the basis of the assets to the transferee unless they exceed the basis of the assets transferred and, thus, trigger gain recognition under section 357(c)(1). Since, under section 357(c)(3), the assumption of a liability deductible to the transferor is not taken into account for purposes of determining whether liabilities exceed basis on the incorporation, such assumption will never increase the gain recognized by the transferor and, therefore, will never increase the transferee's basis in its assets.

Section 357(c)(3) does not apply to liabilities assumed in a section 368(a)(1)(D) reorganization. As a result, the transferor arguably would recognize gain under section 357(c)(1) if assumed contingent liabilities exceeded the basis of the assets. This result makes no sense and a technical correction to extend section 357(c)(3) to D reorganizations would be appropriate. In any event, provided that the reorganization satisfies section 354(b)(1)(A) and (B), the transferee would ultimately be entitled to a deduction for such liabilities by reason of section 381.

transferee the right to deduct expenses of the ongoing business which, if not assumed by the transferee, would have been deductible by the transferor."

1983-2 C.B. 38, 39.²

The second and third bases stated in G.C.M. 39054 clearly apply to the assumption of contingent liabilities in a section 351 transaction. The first basis (distortion of income) is also applicable since, where an entire business is transferred, the liabilities can be viewed as relating to the future production of income of the business.

The letter ruling appropriately extends the rationale of the published rulings to the assumption of liabilities of accrual basis transferors that are not yet deductible for tax purposes. Contingent liabilities of an accrual basis transferor, especially those governed by provisions like section 404(a)(5) and 461(h), are essentially deductible on the cash basis method of accounting. The congressional policy to facilitate business readjustments that was recognized in Rev. Rul. 83-155, as well as the need to preserve cost recovery for the expense in light of the unavailability of a basis increase to the transferee, support the application of Rev. Ruls. 80-198 and 83-155, and not Holdcroft, to the deductibility by the transferee of assumed contingent liabilities.

The Tax Section would be pleased to participate with Treasury and the Service in continuing work on this important subject.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Glen A. Kohl
Eric Solomon
Anne Collier

² The Service also refused to follow Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), where the court denied a deduction for tort liabilities paid by a corporation that had assumed those contingent liabilities upon the incorporation of a partnership.