



CONTINGENT LIABILITIES AND DEFERRED REVENUE IN M&A TRANSACTIONS

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Definition of Contingent Liability

- Liability that may not yet be taken into account for tax purposes because existence or amount depends on future events
- Cash basis taxpayer
 - Taken into account in taxable year when paid (other than certain pre-payments)
 - See Reg. § 1.461-1(a)(1)
- Accrual basis taxpayer (IRC § 461(h))
 - “All events” have occurred which determine the fact of the liability (“fixed”);
 - The amount of the liability can be determined with reasonable accuracy (“determinable”); and
 - “Economic performance” has occurred
 - See Reg. §§ 1.461-1(a)(2)(i), 1.446-1(c)(1)(ii)(A)

Definition of Contingent Liability

- Examples:
 - Environmental remediation costs
 - Accrued vacation
 - Commercial & tort claims
 - Employee benefits (e.g., severance, death benefit)
 - Retiree medical
 - Deferred revenue liability
- Contingent liability vs. asset “defect”

Whether Contingent Liability is Assumed

- Distinguishing between Buyer's own costs and Seller's liabilities assumed by Buyer
- Involves an examination of (case law developed) factors generally focused on:
 1. Does the liability arise from Seller's pre-sale operations or from Buyer's post-sale operations?
 2. Does legal liability occur before or after the acquisition?
 3. Was Buyer aware of the liability?

Contingent Liabilities Giving Rise to Deduction

– *Seller's Treatment: Amount Realized*

- Relief of liabilities is included in amount realized on sale or exchange of property (Reg. § 1.1001-2(a)(1))
- Questions of timing and valuation:
 - Include liability at closing when it is estimated (closed transaction); or
 - Include liability post-closing when it becomes fixed (wait and see)?

Contingent Liabilities Giving Rise to Deduction – *Seller's Treatment: Amount Realized (Example)*

- FACTS:
 - Year 1 → S sells business to P
 - Assets of business include office building on contaminated land
 - No further contamination continuing
 - Cost to remediate land unknown; estimated by S and P to equal \$20X
 - Year 3 → P settles environmental remediation obligation for \$50X
- TIMING/AMOUNT:
 - Does S include \$20X in amount realized in Year 1? or
 - Does S include \$50X in amount realized in Year 3?

Contingent Liabilities Giving Rise to Deduction – Seller's Treatment: Only Lacking Economic Performance

- In the acquisition of a business (i.e., assets), if Buyer expressly assumes Seller's liability arising out of the business, the economic performance test is deemed satisfied at the time Seller includes the liability in amount realized (Reg. § 1.461-4(d)(5)(i))
 - If liability is otherwise fixed and determinable, Seller has no timing mismatch of income inclusion and deduction
 - e.g., liability for breach of contract for which liquidated damages are owed, but payment has not yet been made
 - PLR 200126011 (July 2, 2011) – Buyer acquired all assets of Seller (nuclear plant) and liability to decommission the plant. Held, decommissioning liability fixed and sufficiently determinable at closing to allow Seller deduction in year of closing (*but see* § 468A)
 - What about liabilities that are not fixed and determinable?

Contingent Liabilities Giving Rise to Deduction –*Seller's Treatment: Not Fixed & Determinable*

- If liability not fixed and determinable at closing, then satisfaction of economic performance may not accelerate deduction
 - Does taking into account a specific dollar amount in the net working capital adjustment render liability fixed and determinable?
 - See *Comm'l Security Bank*, 77 TC 145 (1981), acq. 1986-2 C.B. 1 (seller's acceptance of less purchase price is substantively the same as actual payment of liabilities by seller to justify a deduction)
- Why does Seller care?
 - Character (e.g., capital vs. ordinary vs. § 1231 recapture)
 - Timing (e.g., enough income of right character in appropriate year)
 - Administrative costs of carrying back losses

Contingent Liabilities Giving Rise to Deduction

– Seller's Treatment: Not Fixed & Determinable (Example)

- FACTS:

- Year 1 → S sells business to P
 - Business liabilities include accrued vacation liability assumed by P
 - Estimated balance for accrued vacation is \$20X
- During Year 2 → P's actual obligations paid with respect to pre-acquisition accrued vacation is \$50X

- TIMING/AMOUNT:

- Does S include \$20X in amount realized in Year 1?
- Does S include \$50X in amount realized in Year 2?
- Deduct \$20X in Year 1? \$20X in Year 2? \$50X in Year 2?
- See PLR 8939002 (June 15, 1989) (*Comm'l Security* does not apply if treatment is specifically accounted for under the Code)
 - IRC § 404(a)(5) → deduction generally denied under nonqualified deferred compensation until year in which compensation included in employee's income

Contingent Liabilities Giving Rise to Deduction

– Buyer's Treatment

- Buyer takes the assumed liability into account when the liability becomes fixed, determinable, and economic performance has been satisfied
 - See Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2)(i)
- Deduct or capitalize into basis of acquired assets?
 - Greater support for capitalization
 - See *Illinois Tool Works, Inc. v. Comm'r*, 117 T.C. 39 (2001), aff'd, 355 F.3d 997 (7th Cir. 2004); *Webb v. Comm'r*, 77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983); *Holdcroft Trans. Co. v. Comm'r*, 153 F.2d 323 (8th Cir. 1946); *Pacific Trans. Co. v. Comm'r*, 483 F.2d 209 (9th Cir. 1973). Cf. *Nahey v. Comm'r*, 196 F.3d 866 (7th Cir. 1999)
 - Cases that support deduction by Buyer suggests liability was not in fact assumed but was result of independent action post-closing
 - See *Albany Car Wheel Co. v. Comm'r*, 40 T.C. 831 (1964), aff'd, 333 F.2d 653 (2d. Cir. 1964); *United States v. Minneapolis & St. Louis Ry. Co.*, 260 F.2d 663 (8th Cir. 1958).

Deferred Revenue

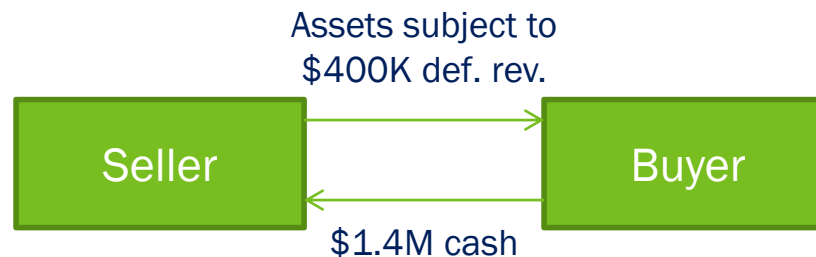
- General rule, advance payments taxable upon receipt
 - See IRC § 451; *Auto. Club of Mich. v. Comm'r*, 353 US 180 (1957); *AAA v. US*, 367 US 687 (1961); *Schlude v. Comm'r*, 372 US 128 (1963)
 - Advance payment vs. deposit
- For tax purposes, deferred revenue occurs when recognition of advance payment in taxable income is deferred beyond year of receipt
 - IRC § 455; Reg. § 1.451-5 (2 years); Rev. Proc. 2004-34 (1 year)
- Examples:
 - Prepaid subscriptions (IRC § 455)
 - Gift cards (Treas. Reg. § 1.451-5; Rev. Proc. 2004-34)
 - Layaway sales (Treas. Reg. § 1.451-5)
 - Membership fees (IRC § 456)
 - Extended service/warranty plans (Rev. Proc. 2004-34)

Deferred Revenue: Is it a Contingent Liability?

- Conceptually, advance payment transactions eligible for deferral can be broken into 2 components:
 - Advance payment by customer to vendor is akin to a loan from customer to vendor to be repaid in goods or services
 - When performance occurs, the delivery of goods or services is a separate recognition event
 - If deferral period ends in taxable year prior to taxable year in which performance occurs, vendor has timing mismatch of income inclusion and deduction of performance costs (e.g., COGS, salary, etc.)
 - Customer never recognizes income
- Assumption of deferred revenue liability in asset acquisition causes deferral period to end
 - See, e.g., Regs. § 1.451-5(f), Rev. Proc. 2004-34, § 5.02(2).
- 2015/2016 priority guidance list

Deferred Revenue in Asset Purchase

– *Pierce v. Comm’r*, 326 F.2d 67 (8th Cir. 1964)



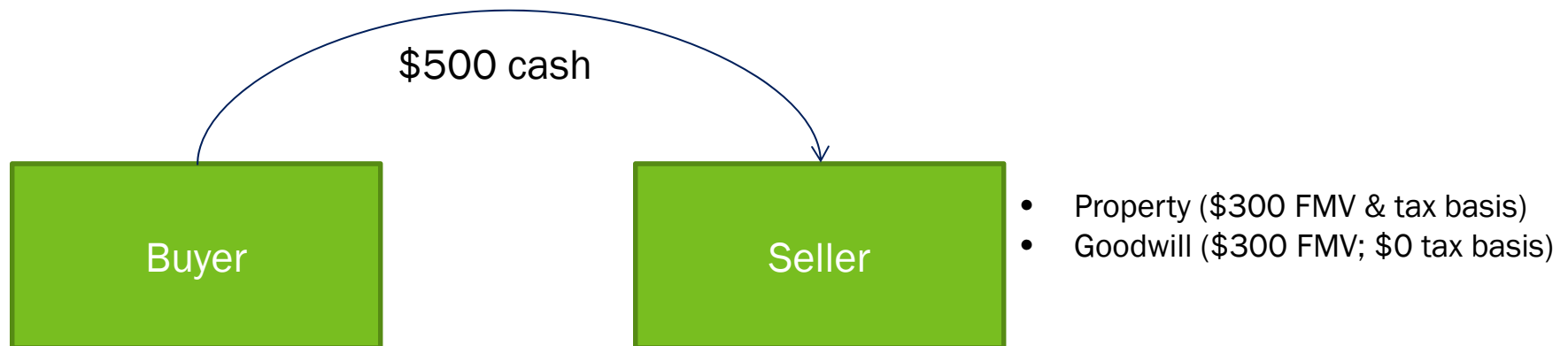
- Seller was publishing business; sold newspaper subscriptions for fixed terms beyond 1 year; advance payment made by the subscriber
 - Deferred recognition of advance payments until performance obligations and accompanying expenses were incurred
- Buyer purchased all of Seller’s assets and assumed all of Seller’s liabilities, including those for unexpired subscriptions
 - Seller did not report the unearned subscription balance as taxable income in the year of closing

Deferred Revenue in Asset Purchase

– *Pierce v. Comm’r* : Seller Results

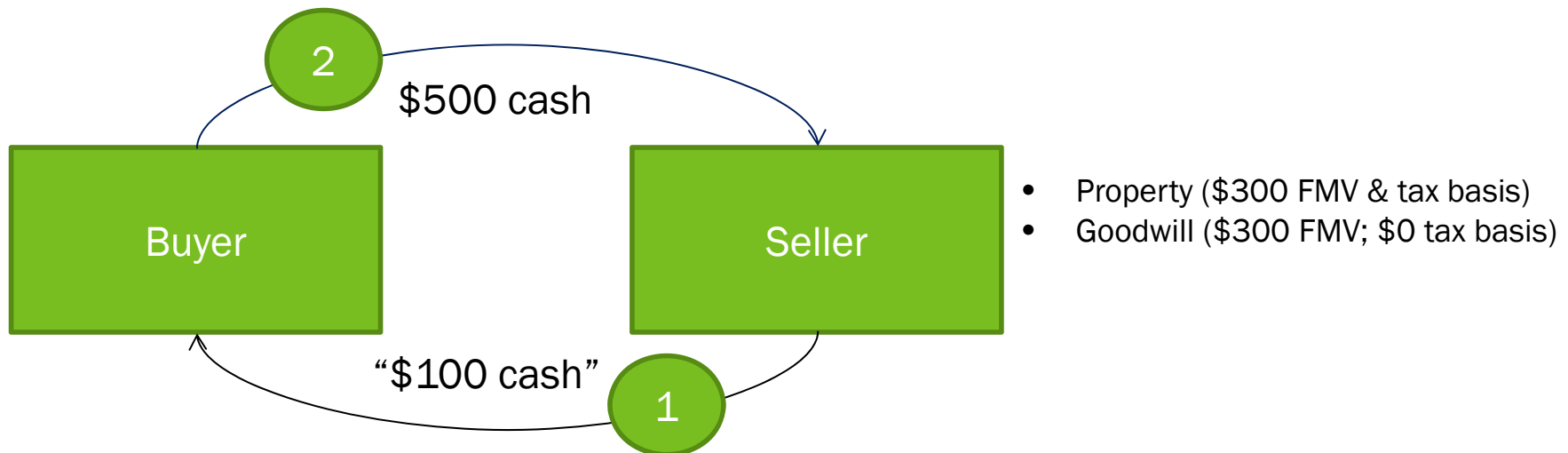
- Seller income inclusion:
 - Buyer’s assumption of Seller’s unearned subscription balance resulted in \$400K ordinary income to Seller upon closing (i.e., the balance not previously included in income)
- Seller deduction:
 - Seller entitled to equal, offsetting deduction to reflect “payment” to Buyer to satisfy Seller’s performance obligation
 - i.e., in transaction “separate” from sale of Seller’s assets, Seller deemed to make payment to Buyer equal to the amount by which the purchase price for Seller’s assets was reduced to reflect the assumed performance obligations
- Court did not discuss effect on Seller’s amount realized in asset sale transaction
 - See GCM 34418 (Feb. 3, 1971) (assumed deferred revenue liability not included in Seller’s amount realized in asset sale transaction)

Example 1: Pierce



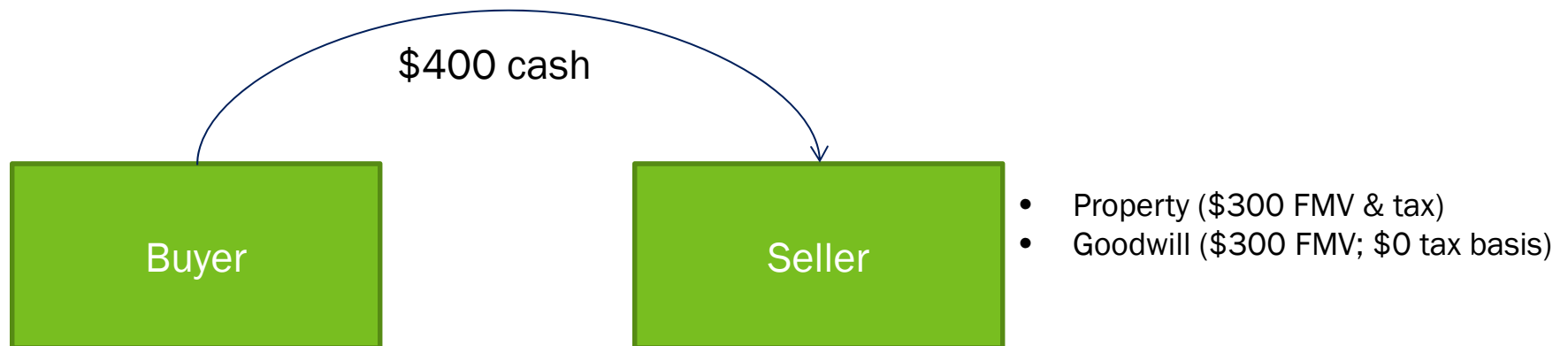
- Year 1 → Seller receives \$100 advance payment to provide services to X in Year 2; uses \$100 to buy more tangible personal property; defers recognition of \$100
 - Estimated costs to perform in Year 2 = \$80
- Year 2 → Buyer acquires all of Seller's assets for \$500 cash, plus assumption of deferred revenue liability
 - Reduction in purchase price = \$100

Example 1: Seller Results under Pierce



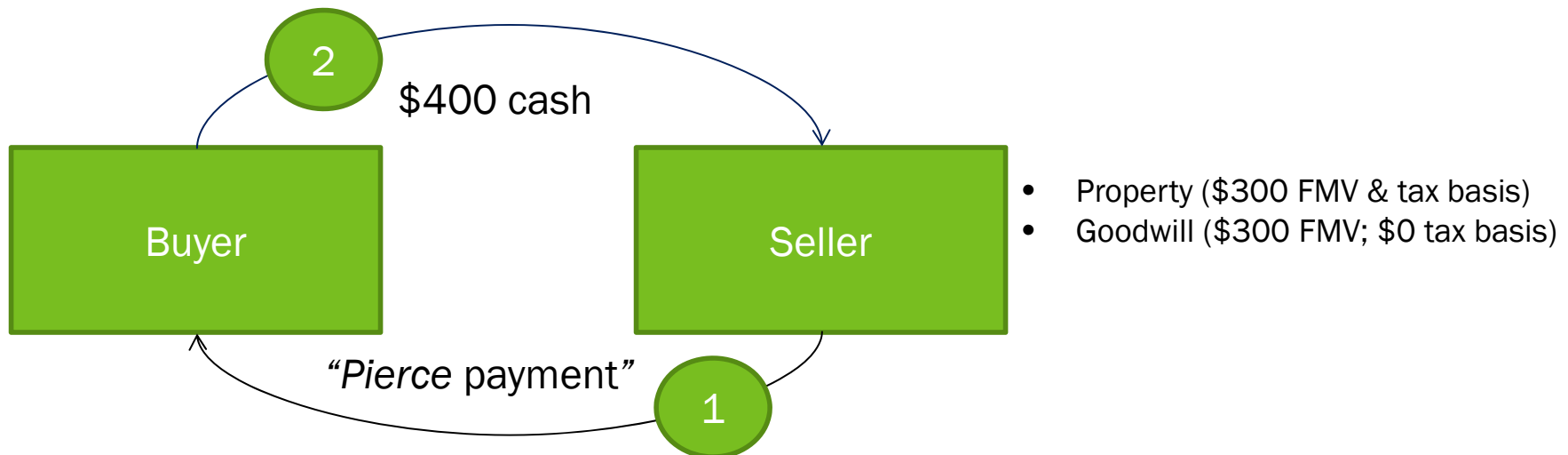
1. *Pierce Payment*: Transfer \$100 of assets to Buyer as compensation for Buyer assuming deferred revenue liability
 - Seller gets \$100 deduction; amount realized = tax basis
2. *Sale Transaction*:
 - Assumption of deferred revenue liability results in \$100 ordinary income for Seller
 - \$300 capital gain (\$500 purchase price, less \$200 basis in remaining assets)
3. *Net Results* → \$0 ordinary income; \$300 capital gain

Example 2: Pierce



- Seller's financial statements show a deferred revenue balance of \$200
 - For tax purposes, Seller has recognized in a prior period \$120 of such balance (i.e., \$80 remaining unrecognized)
- Buyer acquires Seller's assets for \$400, plus assumption of deferred revenue liability
 - Purchase price is reduced by \$200 to reflect assumption of deferred revenue liability

Example 2: Seller Results under Pierce



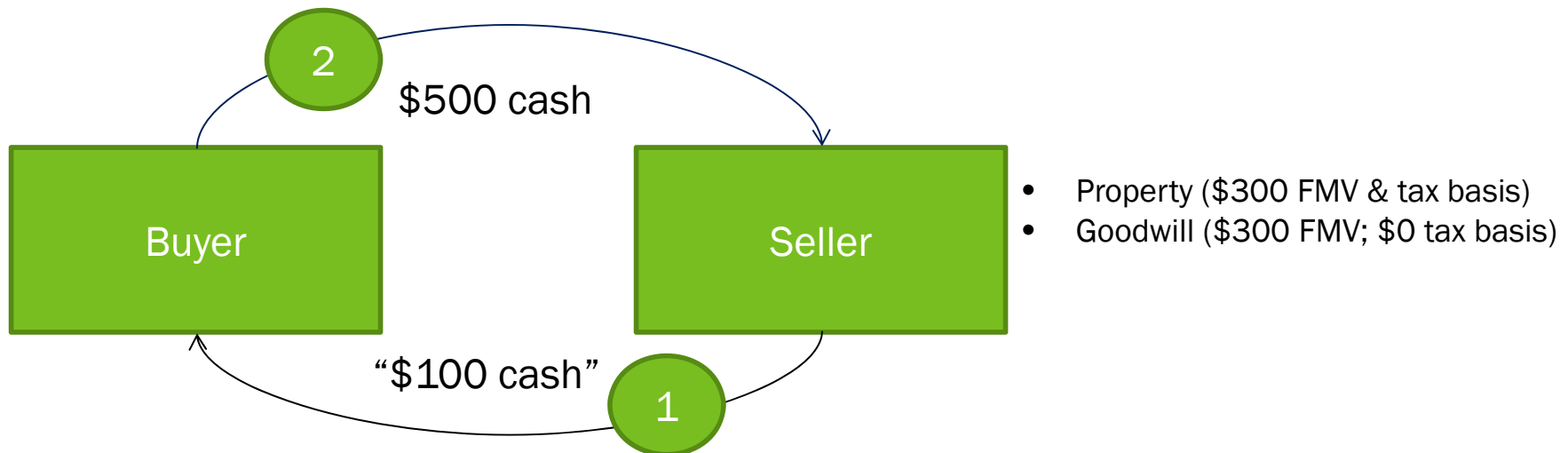
1. Pierce Payment: Transfer of assets to Buyer as compensation for Buyer assuming deferred revenue liability
 - Seller gets deduction → \$200? or \$80?
2. Sale Transaction:
 - Assumption of deferred revenue liability results in \$80 ordinary income (amount not yet recognized)
 - Capital gain (\$400 purchase price, less basis in remaining assets)
 - Basis is \$100? or \$220?
 - Capital gain is \$300? or \$180?

Deferred Revenue in Asset Purchase

– *Pierce v. Comm’r*: Buyer Results

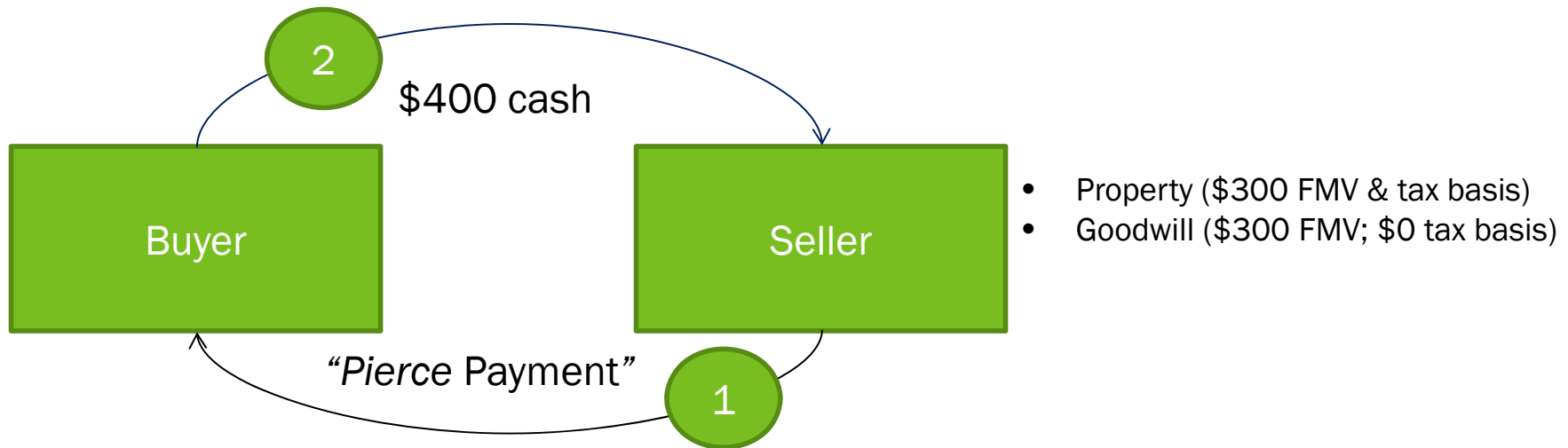
- Court did not directly discuss results to Buyer
- “Separate” transaction (i.e., deemed payment from Seller) presumably causes Buyer to recognize ordinary income upon closing
 - See Rev. Rul. 71-450 (actual payment made to Buyer)
 - Presumably, Buyer can defer recognition under § 455, Reg. § 1.451-5 (up to 2 years) or Rev. Proc. 2004-34 (up to one year)
 - See PLR 8749076 (Sept. 11, 1987) (permitting deferral by Buyer)
- Performance costs incurred by Buyer deductible under general rules
 - See PLR 8749076 (Sept. 11, 1987) (permitting deduction by Buyer)

Example 1: Buyer Results under Pierce



1. *Pierce Payment*: Transfer \$100 of assets to Buyer as compensation for Buyer assuming deferred revenue liability
 - Buyer has \$100 ordinary income inclusion
 - Buyer likely able to defer recognition
2. *Sale Transaction*:
 - Buyer gets immediate basis for purchase price, plus assumed liability (i.e., \$600 basis, allocated \$300 to property and \$300 to goodwill)
3. Buyer can deduct actual costs incurred to perform (~\$80)

Example 2: Buyer Results under Pierce



1. *Pierce Payment*: Transfer of assets to Buyer as compensation for Buyer assuming deferred revenue liability
 - Buyer has ordinary income inclusion → \$200? or \$80?
 - Buyer likely able to defer recognition
2. Sale Transaction:
 - Buyer gets immediate basis for purchase price, plus assumed liability (i.e., \$400 + \$200? or + \$80?)
3. Buyer deducts actual costs incurred to perform (~\$80)

Deferred Revenue in Asset Purchase

– *Problems with Pierce?*

- Conflict between IRS and Justice Department as to the validity of *Pierce* and its progeny
 - See GCM 34418 (Feb. 3, 1971)
- Scope of application of *Pierce*
 - Only applies when deferred revenue expressly assumed by Buyer?
 - What if included in net working capital adjustment?
 - PLR 8612050 (Dec. 23, 1985) (deferred revenue taken into account in a net equity adjustment was sufficient for *Pierce* to apply)
 - What if included in “Indebtedness”?
 - Only applicable in publishing industry where IRC § 455 used to account for subscription income and obtain tax deferral?
 - Does it apply only if amounts are deferred under tax principles?
 - What if negotiated purchase price reduction differs from the face amount of deferred revenue?

Deferred Revenue in Asset Purchase – *Assumption Approach*

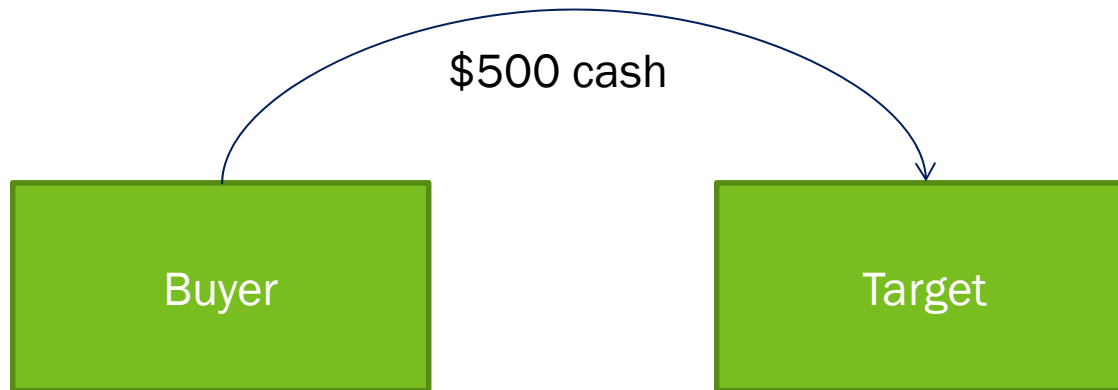
- Assumed deferred revenue liability treated like any other contingent liability
 - Buyer Treatment:
 - No income inclusion for Buyer upon assumption of deferred revenue
 - Buyer's basis not increased until all events test satisfied and economic performance has occurred
 - Seller Treatment:
 - Assumed deferred revenue liability included in amount realized
 - Assumption of deferred revenue causes ordinary income inclusion for Seller upon closing
 - Does Seller get an offsetting deduction?

Deferred Revenue in Asset Purchase

– *Assumption Approach*

- *Oxford Papers*, 194 F.2d 190 (2d Cir. 1952)
 - Affiliate company transferred unfavorable lease to Taxpayer, together with \$100K cash, \$6K stock, and \$350K of other property
 - 2nd Cir. held substance of transaction was a sale of assets by Affiliate to Taxpayer for sole consideration of assumption of lease liability
 - No income inclusion for Taxpayer on receipt of assets
- FSA 200048002 (Dec. 1, 2000)
 - Provides that Seller must include deferred revenue in ordinary income and amount realized; no mention of Seller's deduction
 - Buyer includes deferred revenue liability in basis under general principles of tax law
- Rev. Rul. 76-520 → Capitalize Buyer's performance costs

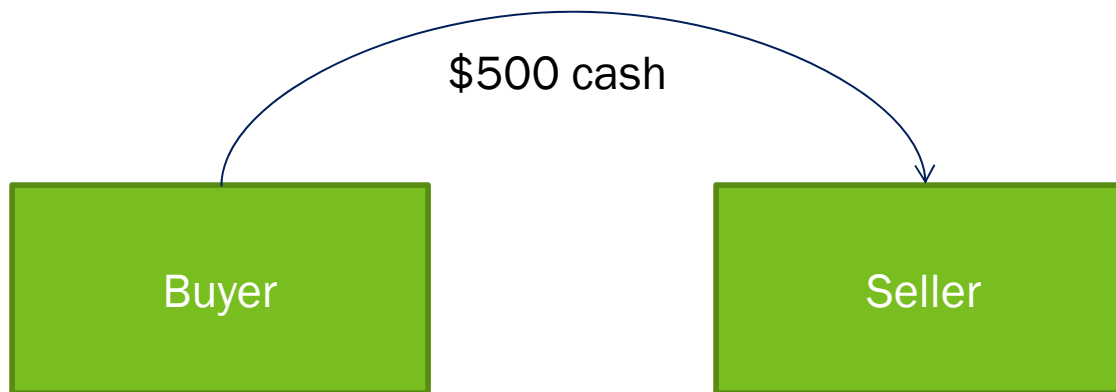
Example 1: Assumption Approach



- Property (\$300 FMV & tax basis)
- Goodwill (\$300 FMV; \$0 tax basis)

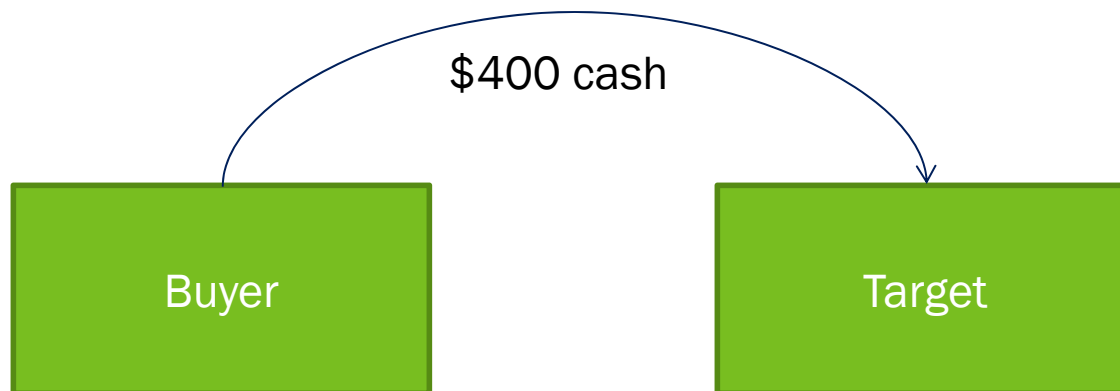
- Year 1 → Target receives \$100 advance payment to provide services to X in Year 2; uses \$100 to buy additional property
 - Defers recognition of \$100 payment
 - Estimated costs to perform in Year 2 = \$80
- Year 2 → Buyer acquires all of Target's assets for \$500 cash + assumption of deferred revenue liability

Example 1: Results under Assumption Approach



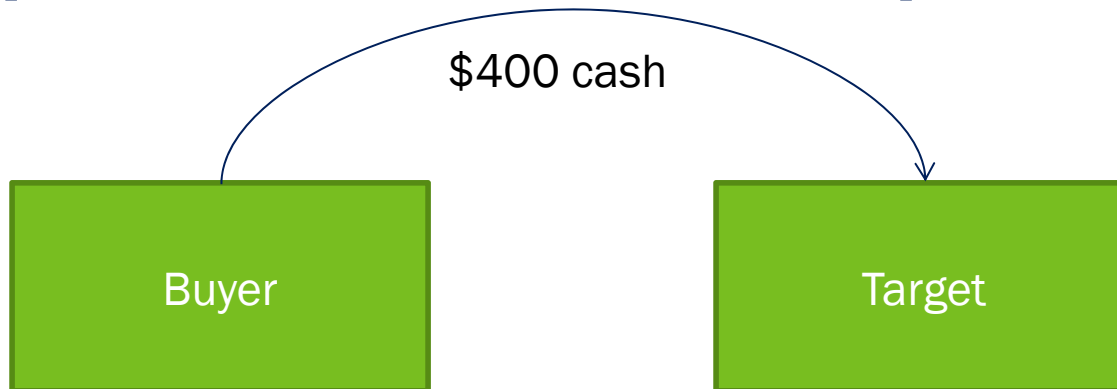
- Property (\$300 FMV & tax basis)
 - Goodwill (\$300 FMV; \$0 tax basis)
- Buyer gets \$500 initial basis
 - Adds liability assumption (\$100) and performance costs (~\$80) to basis when all events test and economic performance satisfied
 - Seller recognizes \$100 ordinary income upon closing (i.e., deferred revenue balance not previously included in income)
 - Seller recognizes \$300 capital gain (\$500 cash + \$100 assumed liability, less \$300 tax basis)
 - Can Seller deduct \$100 if purchase price reduced by \$100?
 - If so, when?

Example 2: Assumption Approach



- Property (\$300 FMV & tax basis)
 - Goodwill (\$300 FMV; \$0 tax basis)
- Seller's financial statements show a deferred revenue balance of \$200
 - For tax purposes, Seller has recognized in a prior period \$120 of such balance (i.e., \$80 remaining unrecognized)
 - Buyer acquires Seller's assets for \$400, plus assumption of deferred revenue liability
 - Purchase price is reduced by \$200 to reflect assumption of deferred revenue liability

Example 2: Results under Assumption Approach



- Property (\$300 FMV & tax basis)
- Goodwill (\$300 FMV; \$0 tax basis)

- Seller recognizes \$80 of ordinary income (i.e., deferred revenue balance not previously included in income)
- Seller has \$300 capital gain (\$400 cash + \$200 assumed liability, less \$300 tax basis)
 - Can Seller deduct \$200 for purchase price reduction?
 - If so, when?
- Buyer's initial basis is \$400
 - Adds liability assumption (\$200) and performance costs (~\$80) to basis when all events test and economic performance satisfied
- Note → Discrepancy between \$600 amount realized and \$680 basis

Comparison of Deferred Revenue Results

HYPOS	RESULTS			
	OI	CG	BASIS	DEDUCTION
Ex. 1 - <i>Pierce</i>				
• Seller	\$100	\$300	--	\$100
• Buyer	\$100	--	\$600	~\$80
Ex. 1 - Assumption Approach				
• Seller	\$100	\$300	--	?
• Buyer	\$0	--	\$600 + ~\$80	\$0
Ex. 2 - <i>Pierce</i>				
• Seller	\$80	\$300	--	\$200
• Buyer	\$200	--	\$600	~\$80
Ex. 2 - Assumption Approach				
• Seller	\$80	\$300	--	?
• Buyer	\$0	--	\$600 + ~\$80	\$0