
Tax Treatment of Contingent Liabilities on the Sale of a Business

Paul M. Crimmins

Follow this and additional works at: <https://via.library.depaul.edu/law-review>

Recommended Citation

Paul M. Crimmins, *Tax Treatment of Contingent Liabilities on the Sale of a Business*, 40 DePaul L. Rev. 819 (1991)

Available at: <https://via.library.depaul.edu/law-review/vol40/iss3/6>

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Law Review by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.

TAX TREATMENT OF CONTINGENT LIABILITIES ON THE SALE OF A BUSINESS

Paul M. Crimmins*

INTRODUCTION

When an individual decides to sell a business, one important issue is whether the buyer or the seller will be responsible for the seller's previously created liabilities.¹ The seller would of course like the buyer to assume all liabilities with little or no offset to the purchase price. The buyer, however, almost always will demand an offset equal to the liabilities she assumes. To negotiate the transfer of the seller's liabilities, both parties must be aware of the tax implications resulting from the allocation of the seller's liabilities and the method by which this allocation is made.

Where the liabilities involved are fixed, the tax consequences to the buyer and the seller are clear. Should the buyer assume a fixed liability of the seller, the buyer will include the amount of this liability in her cost basis.² The seller

* Associate, Much Shelist Freed Denenberg Ament & Eiger, P.C.; J.D. *cum laude*, 1989, Loyola University of Chicago School of Law; B.S., 1985, Loyola University of Chicago. This Article is adapted from a paper prepared for the Senior Tax Seminar at the Loyola University of Chicago School of Law. The author wishes to acknowledge the patience and guidance of Professor Jeffrey A. Kwall, Loyola University School of Law.

1. For purposes of this Article, "sale of a business" means a cash acquisition of assets constituting a going concern, that is, a taxable asset acquisition. This Article will not focus on the acquisition of a business by means of a stock acquisition. In that case, the liabilities normally stay with the corporate entity. Additionally, asset acquisitions which qualify as tax-free reorganizations will not be discussed because the treatment of contingent liabilities in these cases is governed by I.R.C. § 381(c)(16) (1988). For a discussion of the tax treatment of contingent liabilities in both taxable and nontaxable acquisitions, see Curtiss, *Tax Aspects—Contingent Liabilities in Acquisitive Corporate Transactions*, 5 OHIO N.U.L. REV. 431 (1975) (discussing the complexities of contingent liabilities); see also Duncan, *The Impact of Contingent Liabilities on Nontaxable and Taxable Capital Changes*, 58 TAXES 336 (1980) (discussing both taxable and nontaxable capital changes).

For a discussion regarding the impact of the seller's liabilities, actual and contingent, upon the purchase price, see Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67 (1973) (suggesting that only items accruable for tax purposes at the date of the sale be considered part of the sales price).

2. A liability assumed in connection with the purchase of an asset is treated as a cost incurred to be included in the basis of the asset acquired. See *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d Cir. 1952) (buyer's cost basis in plant that buyer acquired included seller's rent obligations which buyer assumed); *Forrester v. Commissioner*, 4 T.C. 907 (1945) (face value of seller's obligation assumed included in stock basis); see also Treas. Reg. § 1.1012-1 (1960) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.").

will include the amount of these liabilities in his amount realized.³ To the extent this amount exceeds his cost basis in the assets sold, the seller will realize a taxable gain.⁴ These established principles of tax law enable both parties to anticipate the tax impact of the transfer of a fixed liability.

Where contingent liabilities are involved, however, the tax consequences are not as clear. When the buyer assumes this liability, the Internal Revenue Service ("IRS") has ruled that the buyer will *not* obtain an increase in her cost basis at the time of purchase.⁵ Similarly, due to the indefinite nature of the liability, the seller should not initially include its value as part of his amount realized.⁶ Beyond these principles, however, questions abound. For instance, is the buyer entitled to a deduction if she eventually pays the liability, or must she include this payment in her cost basis in the assets acquired? If the seller retains and pays the liability, is he entitled to a tax benefit and, if so, what is the nature of that benefit? These uncertainties impede the parties' ability to effectively negotiate the transfer of contingent liabilities.

This Article will attempt to resolve some of these uncertainties. Initially, the Article will explain what is meant by the term "contingent liability." Practical considerations and methods by which the buyer can assume or the seller can retain these liabilities will then be reviewed. The Article will then examine the tax impact of each of these methods with a discussion of existing authority. Finally, to the extent possible, conclusions will be drawn regarding the state of existing law.

I. CONTINGENT LIABILITIES

A "contingent liability" is a potential obligation of the seller that, prior to the transfer of assets, (a) is not yet legally binding, or (b) is not yet quantifiable with any reasonable degree of accuracy.⁷ Thus, one might say that the

3. A taxpayer's amount realized is the sum of money received plus the fair market value of other property received. See Treas. Reg. § 1.1001-1 (1957). Since the buyer's assumption of the seller's liability results in discharge of indebtedness income to him, the amount of the liability assumed is included in the seller's amount realized. See I.R.C. § 61 (1988); see also Smith v. Commissioner, 324 F.2d 725 (9th Cir. 1963) (treating the assumption of taxpayer's personal obligation as money received by taxpayer); Hirst v. Commissioner, 51 T.C.M. (CCH) 1597 (1986) (long-term capital gain resulted from transfer of property in satisfaction of a promissory note).

4. I.R.C. § 1001(a) (1988) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . .").

5. Rev. Rul. 55-675, 1955-2 C.B. 567.

6. Contingent liabilities are deemed too indefinite to have an ascertainable fair market value at the time of sale. Albany Car Wheel Co. v. Commissioner, 333 F.2d 653 (2d Cir. 1964) (holding that an obligation under a union contract to pay severance pay upon the occurrence of a contingency was too speculative to include in cost basis of assets acquired upon purchase of business); Rev. Rul. 55-675, 1955-2 C.B. 567. Thus, it is impossible, at the time of sale, to value what the seller has received from the buyer's assumption of the contingent liability.

7. Tech. Adv. Mem. 87-41-001 (June 16, 1987); see also Duncan, *supra* note 1, at 336 (defining contingent liabilities as "potential obligations, known or unknown, that are not deductible for tax purposes by the accrual-basis taxpayer because (a) they are not definite in amount, or (b) they are not susceptible to estimation with any degree of reasonable accuracy").

genesis of the liability (the event giving rise to ultimate liability) occurs prior to the asset transfer. Subsequent to the transfer, the obligation may mature by becoming legally binding and quantified in a definite amount.

The following three cases illustrate the above definition. In *Holdcroft Transportation Co. v. Commissioner*,⁸ the taxpayer acquired the assets of a partnership along with the partnership's liabilities.⁹ Among these liabilities were pending wrongful death and personal injury claims arising from a collision involving a partnership vehicle.¹⁰ At the time of the asset transfer, the liability in *Holdcroft* was contingent because, although the parties to the sale of the partnership anticipated the possibility of judgment, they were uncertain as to whether judgment ultimately would be rendered and, if so, in what amount. The contingency was in fact satisfied after the transfer when judgment was rendered in favor of the plaintiff.¹¹

In *Albany Car Wheel Co. v. Commissioner*,¹² the buyer assumed the seller's contingent liability under a union contract.¹³ The contract between the employer and the union provided that, upon a plant closing, each employee was entitled to between four and eight weeks severance pay, dependent upon how long the employee had been with the company.¹⁴ At the time the taxpayer acquired the assets, \$48,000 in severance pay had accrued.¹⁵ The buyer's liability for this amount, however, was wholly contingent upon the closing of the plant.¹⁶ Thus, although the obligation was quantifiable (and, in fact, quantified), the liability was contingent because it might never have become legally binding.¹⁷

In *W.D. Haden Co. v. Commissioner*,¹⁸ the buyer, by means of an acquisition structured as a merger, acquired all of the seller's assets and assumed all of its liabilities, actual or contingent, existing as of April 30, 1937.¹⁹ In October of 1937, after the merger, the IRS brought an action against the taxpayer for a tax deficiency of the seller dating from 1935.²⁰ This tax deficiency constituted a contingent liability because, at the time of the merger, it was not yet legally binding.

In addition to providing factual examples, these three cases indicate that contingent liabilities can be either anticipated or unanticipated. Anticipated contingent liabilities were illustrated in *Holdcroft* and *Albany Wheel*. In these

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

9. *Id.* at 323.

10. *Id.*

11. *Id.* at 324.

12. 40 T.C. 831 (1963), *aff'd*, 333 F.2d 653 (2d Cir. 1964).

13. *Id.* at 833.

14. *Id.* at 839.

15. *Id.* at 839-40.

16. *Id.* at 841.

17. *Id.*

18. 165 F.2d 588 (5th Cir. 1948).

19. *Id.* at 591-92.

20. *Id.* at 591.

cases, the parties were aware of the possibility that the contingent liability could become binding after the transfer of assets. An unanticipated contingent liability was illustrated in *Haden*. In that case, neither party apparently was aware of the possibility of the subsequent tax deficiency judgment against the seller. For ease of discussion, this Article will focus only on the seller's retention, or the buyer's assumption, of an anticipated contingent liability.

The following example should provide additional assistance in understanding the nature of contingent liabilities. Assume that the parties have agreed that the assets, goodwill, and going concern value of the seller's business are worth \$1,000,000. Assume also that a suit is pending against the business for injuries sustained by a patron on the premises of the business. The parties estimate that if judgment is rendered in favor of the plaintiff, \$150,000 in liability will result. The parties must decide whether the seller will retain the contingent liability or whether the buyer will assume it. The methods by which this decision can be implemented, as well as the impact each method will have upon how much the buyer pays at closing, will now be examined.

In the following discussion, assume that two years following the sale, judgment in the amount of \$150,000 is rendered in favor of the plaintiff. Thus, for the sake of our analysis, the contingent liability has matured in the amount that the parties estimated.

A. Seller Retains the Liability

Normally, in an asset purchase, if the buyer refuses to assume the seller's contingent liabilities, the seller will be legally obligated to satisfy these liabilities when they mature.²¹ In these instances, the seller can either satisfy the

21. It is well established that a buyer acquiring the seller's assets is not responsible for the seller's liabilities. *E.g.*, *Oak Distrib. Co. v. Miller Brewing Co.*, 370 F. Supp. 889 (E.D. Mich. 1973); *Valley Bank v. Malcolm*, 23 Ariz. 395, 204 P. 207 (1922); *H.M. Chase Corp. v. Idaho Potato Processors, Inc.*, 96 Idaho 398, 529 P.2d 1270 (1974); *Commercial Nat'l Bank v. Newton*, 39 Ill. App. 3d 216, 349 N.E.2d 138 (1976); *J.F. Anderson Lumber Co. v. Myers*, 296 Minn. 33, 206 N.W.2d 365 (1973); *Lamb v. Leroy Corp.*, 85 Nev. 276, 454 P.2d 24 (1969); *Hartford Accident & Indem. Co. v. Canron, Inc.*, 43 N.Y.2d 823, 373 N.E.2d 364, 402 N.Y.S.2d 565 (1977); *Buehler v. United States Fashion Plate Co.*, 269 Pa. 428, 112 A. 632 (1921); *Bowyer v. Boss Tweed-Clipper Gold Mines, Inc.*, 195 Wash. 25, 79 P.2d 713 (1938).

There are some noteworthy circumstances where the buyer might find herself burdened with the seller's contingent liability, notwithstanding that she refused to assume these liabilities. The following cases represent exceptions to the general rule that an asset purchaser is not responsible for the seller's liabilities:

- 1) De facto merger: If a court finds that a purported sale of assets constituted a "de facto merger," the matured liability may be imposed on the purchasing corporation. *E.g.*, *Goldstein v. Gardner*, 444 F. Supp. 581 (N.D. Ill. 1978); *Fehl v. S.W.C. Corp.*, 433 F. Supp. 939 (D. Del. 1977); *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797 (W.D. Mich. 1974).
- 2) Fraud on creditors: If the transfer of assets is found to constitute a fraud on the seller's creditors, the seller's liability to these parties may be imposed upon the buyer. *American Ry. Express v. Commonwealth*, 190 Ky. 636, 228 S.W. 433 (1920).
- 3) Equitable considerations: Courts have imposed the seller's liability upon the buyer due to equitable considerations, for example, where the seller, standing alone, was not able to compensate the

liability directly as it arises, or the parties can decide to use an indemnification clause to facilitate the seller's payment of the liability. In either case, the seller will be left with the economic burden of payment. Where the seller decides to pay the liability directly, the following scenario will occur. The buyer will pay \$1,000,000 at the time of closing, leaving the seller with up to \$1,000,000 with which to pay any contingent liabilities that accrue in the future. Two years later, when judgment is rendered, the seller will pay \$150,000 to the plaintiff.

In lieu of requiring the seller to pay the liability directly, the parties could agree that payment of the liability will be governed by an indemnity clause. Pursuant to such a clause, the seller will agree to indemnify the buyer for any costs she incurs in satisfying the contingent liability.²² In this case, the buyer would pay \$1,000,000 at closing. When judgment is rendered two years later, the buyer will pay the plaintiff \$150,000 in satisfaction of the judgment. Pursuant to the indemnity clause, the seller will then reimburse the buyer \$150,000.

Where an indemnification clause is used, the buyer will suffer a temporary loss of funds until the seller fulfills his duty of indemnification. If the parties

injured party. *Knapp v. North Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975).

4) Product liability theories: The traditional rule exempting an asset purchaser from assumption of the seller's liabilities is changing in the product liability area. Certain states, under a number of doctrines, have held asset purchasers liable for postsale product liability claims arising from products manufactured and placed in the stream of commerce by the seller, notwithstanding that these purchasers did not assume these liabilities. For a discussion of these doctrines, and an overview of the case law in this area, see Buser, *Strict Products Liability Litigation in Review*, 70 ILL. B.J. 148, 153-54 (1981) (noting that California courts were adopting a strict liability exception to the traditional successor liability rule but that Illinois courts had not yet done so); Fegan, *Successor Corporations and Strict Liability in Tort—A Convergence of Two Opposing Doctrines*, 69 ILL. B.J. 142, 142 (1980) (discussing the possibility of courts holding successor corporations strictly liable in tort for claims arising against seller corporations); Hundley, *Business Expansion Through Asset Acquisition: Some Problems Posed by Product Liability Doctrines*, 77 ILL. B.J. 492, 495 (1989) (noting that while a buyer generally does not assume the liabilities of a seller, a minority of states have begun to include strict product liability claims as an exception to that general rule). The majority of these types of product liability claims could be characterized as contingent liabilities as they are not legally binding or quantifiable at the time the buyer purchases the assets.

5) Practical considerations: The buyer might find herself compelled to satisfy the contingent liability when it matures due to practical reasons, such as maintaining the business' goodwill.

The five situations outlined above pose a special risk to the buyer in that she could find herself unexpectedly burdened with a liability without having obtained indemnity protection or an offset to the purchase price. In these cases, the buyer would have paid \$1,000,000 for the business upon closing, but the imposition of the \$150,000 contingent liability would increase the buyer's cost to \$1,150,000. Thus, the buyer would have paid \$150,000 more than the business was worth. Any possible tax benefit arising from the assumption of the seller's contingent liability would accordingly take on added importance in such a case.

22. See Comment, *The Tax Consequences of Contingent Liabilities in the Acquisition of a Business*, 1968 U. ILL. L.F. 84, 87 (stating that indemnification is used when the parties have anticipated liability but the buyer wishes to avoid adverse tax consequences after the transfer).

anticipate a substantial delay in indemnification, the buyer should demand that the indemnity clause contain an interest provision in order to compensate for the loss of funds.

B. Buyer Assumes the Liability

The buyer might agree to assume the contingent liability, but she should demand an equivalent offset to the purchase price for doing so. Thus, under the example, the buyer will agree to pay only \$850,000 upon closing and assume the contingent liability valued at \$150,000. Note that if the contingent liability does not mature, the buyer will have obtained a business worth \$1,000,000 for only \$850,000. Likewise, if the liability matures at an amount over \$150,000, the buyer will have effectively paid more than the agreed asset purchase price. Therefore, the probability that the contingent liability will mature factors into the value that the parties place on it.²³

Should the buyer assume the contingent liability, she can either pay it directly as the contingency arises, or pay the liability by use of a set-aside technique. A set-aside technique permits the parties to satisfy the contingent liability from the purchase fund itself. This technique is advisable for the buyer, as it caps the amount of the payment she will make to discharge the contingent liability. A set-aside may be accomplished either by the use of an escrow arrangement or by including a contingent payment clause in the purchase agreement.

Under the escrow arrangement, the buyer will deposit a portion of the purchase payment in escrow. The escrow agent will hold the funds for an agreed upon period of time. If the contingent liability matures during the existence of the escrow, the escrow agent will satisfy the liability with the escrowed funds. When escrow terminates, any remaining funds will be paid to the seller.²⁴

In the example described above, the buyer would place \$150,000 in escrow. Assume that the parties agree that the escrow will terminate three years after the sale. Further assume that two years after the sale, the contingent liability matures in the amount of \$150,000 and the buyer satisfies it with the escrowed funds. No funds remain to be paid to the seller. The advantage in using this technique is that each party is fully assured that the funds will be used as intended. The detriment is that neither party has use of the funds during the escrow period.²⁵

23. "To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real." *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988). For purposes of this example, assume that in determining the contingent liability's value at \$150,000, the parties have factored in the probability that the contingent liability will mature.

24. See generally R. JACOBS, *Escrows and Their Tax Consequences*, in NEW YORK UNIVERSITY, PROCEEDINGS OF THE THIRTY-NINTH INSTITUTE ON FEDERAL TAXATION § 5.02 (1981) (analyzing the use of escrow to protect against contingent liabilities).

25. The parties may, of course, determine how the interest earned on the escrowed funds is to

Pursuant to the second set-aside technique, a contingent payment clause, the buyer withholds a portion of the purchase price for a certain period. If the contingent liability matures during this period, the buyer will satisfy the liability with the withheld funds. Any amounts remaining when the period expires will be paid to the seller. Under the example, assume that the parties agree that the buyer will withhold \$150,000 for three years. Two years into this period, the contingent liability matures in the amount of \$150,000 and the buyer satisfies it using the withheld funds. No funds remain to be paid to the seller.

This arrangement is preferred by the buyer as she can retain use and control of the funds while the liability remains contingent. Because of this fact, the buyer is assured that the funds will be used to extinguish the contingent liability. As this concern can be dealt with amply by use of an escrow, the principal advantage of the contingent payment clause to the buyer is that she retains use of the funds. Conversely, the seller usually does not prefer this arrangement, as he is deprived of the use and control of the funds during the period of contingency.

The practical aspects outlined above provide only some of the considerations in negotiating the retention or transfer of the seller's contingent liabilities. The other aspects which must be considered are the tax implications of a particular arrangement.

II. TAX CONSEQUENCES OF ALLOCATING THE SELLER'S CONTINGENT LIABILITIES

A. *The Seller Satisfies the Contingent Liability*

As noted above, the seller can satisfy the contingent liability as it arises by either one of two means. The seller can pay the liability directly; alternatively, the purchase agreement could contain an indemnity clause providing that, if the buyer satisfies the liability, she will obtain reimbursement from the seller. The tax impact upon the seller and the buyer under each alternative will now be examined. Under each alternative, assume that the seller would have been entitled to deduct the contingent liability as a business expense had the liability matured prior to the sale of assets.

1. *Seller Satisfies the Contingent Liability Directly*

a. Impact on the seller

Under this arrangement, the seller will retain the contingent liability and pay it when the contingency matures. The seller's concern in this circumstance is what tax benefit will result from his payment. This section will discuss the tax benefit resulting from the seller's payment in two scenarios. In the first scenario, the seller paying the liability is the former sole proprietor of the busi-

ness that was sold. The sole proprietor's tax benefit in paying the liability will be a business expense deduction against ordinary income. In the second scenario, the "seller" paying the liability is a former shareholder of the corporation that sold the business.²⁶ The former shareholder's tax benefit will be a capital loss deduction against then current capital gain income.

i. Sole proprietor

Normally, payment of a business expense gives rise to a tax deduction against ordinary income.²⁷ Where the business is operated as a sole proprietorship,²⁸ the sole proprietor is entitled to deduct the expense.²⁹ No immediate deduction is allowed, however, for contingent liabilities.³⁰ The deduction is allowed only when the liability matures.³¹ Thus, where the sole proprietor operates a business and a deductible contingent liability matures against that business, the sole proprietor's payment of the liability gives rise to a business expense deduction.

For instance, in the example we have been using, the contingent liability of \$150,000 is outstanding at the time of sale. The issue for the sole proprietor is whether he may deduct the payment of this liability when this payment is made after he terminates the business. In other words, can the sole proprietor claim this as a business expense deduction, even though he has discontinued the business?

The sole proprietor should be able to claim a business expense deduction upon payment of the contingent liability. As a general rule, deductions for business expenses can only be allowed in the taxable year in which payment is actually made or accrued.³² That the sole proprietor made the payment after the transfer of assets in a sole proprietorship should not preclude the deduction. Due to the liability's contingent nature, the sole proprietor could neither pay nor accrue it until after the business was sold. This circumstance alone

26. In these cases, the corporation is technically the seller of the assets. Nevertheless, the former shareholder paying the liability will be referred to as the seller for ease of discussion.

27. I.R.C. § 162 (1988) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business . . .").

28. In the case of a partnership, the business expense deduction is not claimed by the partnership as a separate entity. Rather, each partner, in computing his income tax, takes into account his distributive share of the deduction. I.R.C. § 702 (1988). A partner's distributive share is, generally, his share of the partnership's profits and losses as allocated to him in the partnership agreement. I.R.C. § 704 (1988).

29. See *Choice of Entity*, 456 Tax Mgmt. (BNA) A-18(2) (Apr. 10, 1989) (stating that "the business is not a separate taxpayer and all of the tax consequences are borne by the proprietor").

30. *Union Pac. R.R. v. United States*, 524 F.2d 1343 (Ct. Cl. 1975) (stating that "so long as a liability remains contingent, or if the liability has attached but the amount cannot be reasonably estimated, a business deduction is not allowed"), *cert. denied*, 429 U.S. 827 (1976).

31. *Lustman v. Commissioner*, 322 F.2d 253, 258 (3d Cir. 1963) (holding that "a deductible business expense cannot be claimed until the liability to pay it becomes fixed and certain").

32. *Dowd v. Commissioner*, 68 T.C. 294, 300-01 (1977) ("It is fundamental to the cash basis method of accounting that the mere liability for payment is insufficient and a deduction for a business expense can only be allowed in the taxable year in which payment is actually made.").

should not alter the liability's deductibility as an ordinary and necessary business expense.³³ Any other result would make the availability of a business expense deduction dependent upon the timing of the payment, as opposed to the nature of the payment. The sole proprietor paying the contingent liability should claim the business expense deduction.³⁴

ii. Shareholders

Normally, individual corporate shareholders are not liable for the corporation's liabilities.³⁵ Moreover, a shareholder paying a liability of the corporation is not entitled to deduct that payment.³⁶ Thus, should a contingent liability mature against the corporation, a shareholder would not be obligated to pay it. If he decides to do so, he would not be entitled to deduct his payment. Rather, the payment will be treated as a contribution to the capital of the corporation, thereby increasing the shareholder's basis in the stock by the amount of the payment.³⁷

33. *Id.* (stating that an individual cash basis taxpayer may deduct, when paid, ordinary and necessary business expenses, the liability for which arose in the active conduct of a trade or business, even if the payment is made subsequent to the termination of business); see also *Kaufman v. Commissioner*, 12 T.C. 1114, 1117-18 (1949) (holding that attorney's fees to defend suit arising from operation of a business, paid after discontinuance of the business, are deductible); *Burrows v. Commissioner*, 38 B.T.A. 236, 238 (1938), *acq.*, 1938-2 C.B. 5 (holding that expenses incurred in practicing medicine, paid after discontinuance of the practice, are deductible in the year paid); Rev. Rul. 67-12, 1967-1 C.B. 29 (stating the general rule that ordinary and necessary expenses, incurred in a trade or business in prior years and paid in the current year, by an individual taxpayer who uses the cash method of accounting are deductible even though the trade or business has been discontinued). For a general discussion of the mechanics of how the sole proprietor reports business expenses arising after the termination of his business, see [1991] 6 *Stand. Fed. Tax. Rep. (CCH)* ¶ 2907.5788 (stating that claim deductions of cash basis taxpayers arising after the discontinuance of a sole proprietorship are deductible on Schedule C, Form 1040 in the year paid).

The cases cited above address the cash basis taxpayer. Where contingent liabilities are incurred, the rationale of the above cases also applies to the accrual basis taxpayer. Due to the contingent nature of the liability, the taxpayer was not able to accrue the liability until it matured. If the liability matures after the business terminates, the above cases support a conclusion that the proprietor is permitted to accrue the liability, since accrual was impossible before this point.

34. This is assuming, of course, that the contingent liability qualifies as a deductible business expense. Deductible business expenses include: management expenses, commissions, labor, supplies, incidental repairs, insurance premiums, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of trade or business, advertising, and other selling expenses. *Treas. Reg.* § 1.162-1(a) (1988).

35. See REVISED MODEL BUSINESS CORP. ACT § 6.22(b) (1985) ("Unless otherwise provided for in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation.").

36. *Succession of Harrison v. United States*, 392 F. Supp. 1067, 1068-70 (E.D. La. 1975) (taxpayer's payment of someone else's debt is not an ordinary expense); *Dietrick v. Commissioner*, 55 T.C.M. (CCH) 706, 711-13 (1988) (holding that a shareholder's payment of corporate expenses are nondeductible on the grounds that expenses were those of another taxable entity), *aff'd*, 881 F.2d 336 (6th Cir. 1989).

37. *International Trading Co. v. Commissioner*, 17 T.C.M. (CCH) 521, 529-30 (1958) (stating

An exception to this rule applies where the corporation sells its assets and liquidates. In a liquidation, a shareholder may become obligated to pay corporate contingent liabilities maturing after the sale of assets in two situations. First, the shareholder might stipulate in the asset purchase agreement to assume the contingent liability. However, even in the absence of such express assumption, the shareholder might also be held obligated on the corporation's contingent liabilities as a transferee in liquidation.³⁸ In either of these situations, the shareholder will be obligated to pay the liability.

Referring to our example, assume that corporation, *X*, is the seller of the assets. The buyer refuses to assume the contingent liability and realizes that *X* will probably liquidate after the sale. Therefore, she requires the sole shareholder of *X* to expressly assume the contingent liability. Buyer then pays the \$1,000,000 purchase price to *X*. *X* liquidates two months later. Two years following the sale, judgment is rendered against the corporation in the amount of \$150,000. In order to satisfy his obligation under the asset sale agreement, the former sole shareholder pays \$150,000 to the plaintiff.

The former shareholder is concerned with the issue of what tax benefit, if any, he realizes from his payment of the former corporation's contingent liability. As noted, had the shareholder made this payment before the corporation liquidated, it would have been treated as a contribution to capital, increasing the shareholder's basis in his stock.³⁹ The former shareholder, however, has already disposed of his stock in the liquidation. Consequently, the tax benefit to the former shareholder in this case is a capital loss deduction.⁴⁰ The same result obtains where liability is imposed on the former shareholder as a transferee in liquidation.⁴¹

It is only logical to treat the payment as a capital loss deduction. Had the shareholder paid the liability before the corporation liquidated, he would have

that a shareholder payment of corporate debt results in an increase in stock basis by the amount paid), *aff'd*, 278 F.2d 556 (7th Cir. 1960).

38. See REVISED MODEL BUSINESS CORP. ACT § 14.07(d)(2) (1985). A claim against a dissolved corporation may be enforced against a shareholder of the dissolved corporation if the assets of the dissolved corporation have been distributed in liquidation. A shareholder's total liability for all claims may not exceed the total amount of assets distributed to him. *Id.*

39. See *supra* note 37.

40. *Livingston v. Commissioner*, 25 T.C.M. (CCH) 277, 291-92 (1966) (stating that a shareholder's payment of corporate liability after liquidation gives rise to a capital loss).

41. *Arrowsmith v. Commissioner*, 344 U.S. 6, 8 (1952). In *Arrowsmith*, former shareholders of a liquidated corporation paid a judgment arising against the corporation four years after the last liquidating distribution had been made. *Id.* at 7. This judgment was an unanticipated contingent liability in that, at the time the shareholders decided to liquidate the corporation, the liability had not yet become legally binding nor had the shareholders foreseen the possibility of judgment. Subsequent to the liquidation, the liability became known and legally binding. The Supreme Court held that the proper characterization of the payments was that of a capital loss, rather than as an ordinary business loss. *Id.* at 8. The Court based its decision on the Code's definition of capital losses as the "losses from sales or exchanges of capital assets," and the Code's treatment of liquidating distributions as exchanges. *Id.*; see I.R.C. §§ 1222(2),(4) (1988) (defining short-term and long-term capital losses); *Id.* § 331(a) (distributions in a complete liquidation treated as exchanges).

received an increase in his stock basis.⁴² This increase would have subsequently offset the capital gain income the shareholder realized upon the corporate liquidation.⁴³ Due to the contingent nature of the liability, the shareholder's payment of it was necessarily precluded until after the corporate liquidation. In light of this factor, the shareholder should not be denied the tax benefit he would have otherwise enjoyed.⁴⁴

b. Impact on the buyer

The buyer should be unaffected, for tax purposes, by the seller's payment of the contingent liability. The liability did not belong to the buyer in the first place, nor did she assume the liability in the purchase agreement. Therefore, the seller's payment will not result in discharge of indebtedness income to the buyer.⁴⁵

Moreover, it is difficult to conceive of any other type of taxable benefit accruing to the buyer in this case. Even if the payment of the liability increased the value of the business, this should not give rise to a tax obligation because no realization event has occurred.⁴⁶ Quite simply, the buyer has received no taxable benefit from the seller's payment. True, the seller's payment here arguably benefits the goodwill of the business, which is now in the hands of the buyer. This benefit, however, is essentially an appreciation in the value of the business. Appreciation in value, absent a realization event, does not constitute income to a taxpayer.⁴⁷ In the absence of such a realization event, this benefit is simply too remote to constitute income. In this case, it is simply impossible to identify the buyer's realization event. Therefore, when the seller pays the contingent liability directly, there should be no tax consequence to the buyer.

2. Seller Indemnifies the Buyer for the Cost of Satisfying the Liability

Under this arrangement, the buyer has paid the contingent liability. The seller will then reimburse the buyer. Thus, under the example, the buyer will pay the plaintiff \$150,000 when judgment is rendered. The seller will then reimburse the buyer in this amount.

42. See *supra* note 37 and accompanying text.

43. See I.R.C. § 331 (1988) (stating the rule for computing gain or loss to shareholders in corporate liquidations).

44. Note that the shareholder will not be able to use this capital loss unless he has realized capital gains in the year in which he pays the contingent liability. *Id.* § 1211(b). Given this requirement, one could question whether the shareholder is indeed assured of obtaining the tax benefit he would have otherwise enjoyed.

45. See *id.* § 61(a)(12). Discharge of indebtedness income can result only where the taxpayer is relieved of a debt upon which she is obligated. The buyer's purchase of the seller's assets, without more, does not make her obligated on the seller's liabilities. See *supra* note 21.

46. See I.R.C. § 1001(a),(b) (1988).

47. *Alexander Sprunt & Son v. Commissioner*, 24 B.T.A. 599, 621 (1931) (mere appreciation in value, unrealized by conversion of property, is not income), *aff'd in part and rev'd in part on other grounds*, 64 F.2d 424 (4th Cir. 1933).

a. Impact on the seller

Under the indemnity arrangement, the seller faces two tax issues. The first issue is whether he will realize income from the buyer's initial payment of the contingent liability. The second issue is what tax benefit he will realize by reimbursing the buyer.

The buyer's initial payment of the liability will not result in income to the seller. Since the sale agreement obligates the seller to reimburse the buyer, the buyer's payment of the liability in essence constitutes a loan to the seller. Amounts loaned to a taxpayer do not constitute income.⁴⁸ Accordingly, the seller will not realize income from the buyer's initial payment of the liability.

When the seller reimburses the buyer, he enjoys the same tax benefit as where he pays the contingent liability directly, depending upon the identity of the seller making the payment. If the seller is a sole proprietor, this tax benefit will be a business expense deduction.⁴⁹ If the seller is a shareholder, the tax benefit will be a capital loss deduction.⁵⁰

In the indemnity situation, the seller merely reimburses the buyer for the payment made on his behalf. By this reimbursement, the seller ultimately pays the debt. Accordingly, the same tax consequences should result here as in the case where the seller pays the liability directly.

b. Impact on the buyer

Various tax concerns for the buyer arise under an indemnity provision. The first tax concern is what tax benefit, if any, will result from the buyer's initial payment of the liability. The second concern is whether the indemnity payment will constitute income to the buyer. The final concern is whether the buyer will be able to claim a tax benefit should the seller fail to comply with his obligation to indemnify.

Regarding the first two concerns, *Rogers v. Commissioner*⁵¹ holds that the buyer's initial payment will give rise to a claim against the seller.⁵² Accordingly, the buyer's basis in the claim is increased by the amount she expended in paying the liability. When the seller makes his reimbursement payment, the buyer will realize income only if the reimbursement exceeds her basis in the claim.⁵³ If the seller fails to reimburse, the buyer will be entitled to a short-

48. *Chapman v. United States*, 314 F. Supp. 549, 550-51 (C.D. Cal. 1970) (transfer of money to the taxpayer was a loan, not income, because of the obligation to repay); *Rogers v. Commissioner*, 52 T.C.M. (CCH) 950, 955 (1986) (wire transfer to the taxpayer was a nontaxable loan as evidence showed that the lender intended to enforce repayment terms); Tech. Adv. Mem. 84-25-005 (Mar. 1, 1984) (state's payment of interest on the taxpayer's behalf did not constitute income to the taxpayer because of absolute obligation to repay the state).

49. See *supra* notes 27-34 and accompanying text.

50. See *supra* notes 35-44 and accompanying text.

51. 5 T.C. 818 (1945), *acq.*, 1946-1 C.B. 4.

52. *Id.* at 822.

53. See I.R.C. § 1001(a) (1988).

term capital loss deduction.⁵⁴

An examination of the *Rogers* case shows the significance of allocating the buyer's payment to the basis of the claim against the seller. In *Rogers*, the taxpayer had purchased a tract of land from the seller by warranty deed.⁵⁵ The deed fully warranted title free and clear of all encumbrances and liens except for certain *ad valorem* taxes. Subsequent to the sale, additional back taxes were assessed against the property. The buyer paid these taxes.⁵⁶

The Tax Court in *Rogers* held that upon making these payments, the buyer obtained a claim against the seller.⁵⁷ The Tax Court rejected the IRS' argument that the payment should be immediately included in the buyer's basis in the land.⁵⁸ Had the Tax Court accepted this argument, the buyer would not have been able to recover the basis gained from the payment until he sold the land. Thus, when the seller reimbursed the buyer, the entire amount of reimbursement would constitute income, as no basis would have been allocated to the buyer's claim. Under the rule set forth in *Rogers*, however, the buyer's payment is allocated to the basis of the *claim* against the seller.⁵⁹ Thus, where the seller's indemnity payment equals the buyer's cost in satisfying the liability, no income will result to the buyer.

The buyer's basis in the claim is the amount she expended in paying the liability.⁶⁰ In our example, the buyer's basis in the claim is \$150,000, the amount she advanced to the plaintiff to satisfy the formerly contingent liability. If the seller's reimbursement does not exceed this amount, the buyer realizes no gain from the payment.⁶¹ Assume that the seller indemnifies the buyer according to the purchase agreement for \$150,000. No income will result to the buyer as seller's payment equals the basis in the claim.

As for the buyer's final tax concern, where the seller is unable to comply with his duty to indemnify, the buyer may claim a bad debt deduction.⁶² The amount of the deduction will be the buyer's basis in the claim, in other words, her cost in paying the contingent liability.⁶³ The character of the buyer's bad

54. *See id.* § 1222(2).

55. *Rogers*, 5 T.C. at 820.

56. *Id.*

57. *Id.*

58. *Id.* The IRS contended that the payment represented an additional cost of the property, in the nature of a capital investment. *Id.*

59. *Id.* at 822 (emphasis added) ("However, the payment of such delinquent taxes by petitioner in 1941 did not operate to increase by that amount the purchase price of the property, but operated merely to create a claim therefor against the vendor.").

60. I.R.C. § 1012 (1988) (providing that "[t]he basis in property shall be the cost of such property"). The buyer's cost in the claim against the seller is the amount expended to pay the contingent liability.

61. *Id.* § 1001 ("The gain from the sale or *other disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis" (emphasis added)).

62. *Rogers v. Commissioner*, 5 T.C. 818, 822 (1945), *acq.*, 1946-1 C.B. 4.

63. I.R.C. § 166(b) (1988) ("[T]he basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in Section 1011.").

debt deduction will be that of a short-term capital loss.⁶⁴

B. Buyer Assumes the Contingent Liability

The buyer can become responsible for the seller's contingent liability in one of three ways. The buyer could assume the liability and then pay it directly. Alternatively, the buyer could place a portion of the purchase funds in escrow. The escrow funds would either be used to pay the liability or, in the event the liability did not mature, the escrow could be paid directly to the seller. The third alternative would be for the buyer to withhold a portion of the purchase price pending the ultimate disposition of the contingent liability. The withheld funds would be used either to satisfy the liability or would be paid to the seller. A common feature of all three arrangements is that the buyer ultimately pays the liability, although in the escrow or withholding arrangements, the buyer's obligation is limited to the amount set aside. The tax impact upon the buyer and the seller under each arrangement will now be examined.

1. Buyer Assumes the Liability and Pays it upon Maturity

a. Impact upon the buyer

In this scenario, the buyer will pay \$850,000 upon closing, assuming the contingent liability is valued at \$150,000. If this liability ever matures, the buyer will pay it directly to the plaintiff. In this situation, the buyer is concerned with the nature of the tax benefit arising from her assumption and payment of the contingent liability.

Unlike the assumption of a fixed liability, the buyer is not permitted to include the value of a contingent liability assumed in her cost basis at the time of purchase.⁶⁵ The rationale for this rule is that these liabilities are so indefinite that they are not capable of present valuation for purposes of determining cost basis.⁶⁶ An alternative rationale for precluding contingent liabilities from the buyer's cost basis goes to the contingent nature of the liability: the buyer has not yet really assumed any additional burden and, consequently, should not yet be permitted to increase her basis. Accordingly, upon closing, the buyer will have a basis of \$850,000 in the assets; the \$150,000 contingent liability will not be included in basis at this time.

64. *Id.* § 166(d)(1)(B) ("[W]here any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months."). The buyer's claim must be considered a nonbusiness bad debt since it was incurred in connection with the purchase of assets, not the operation of a trade or business. *See id.* § 166(d)(2).

65. *Albany Car Wheel Co. v. Commissioner*, 333 F.2d 653 (2d Cir. 1964) (seller's obligation under a union contract, which buyer assumed, was too speculative and contingent to be included in the cost basis of assets acquired); Rev. Rul. 55-675, 1955-2 C.B. 567 (stating general rule).

66. *Cf. Ferris v. Commissioner*, 27 T.C.M. (CCH) 937, 939-40 (1968) (contingent obligation deemed not includible in the basis of the patent acquired); *Redford v. Commissioner*, 28 T.C. 773, 778 (1957) (where payment of a note was subject to a contingency, taxpayer could not include the note in the basis of property acquired); Rev. Rul. 55-675, 1955-2 C.B. 567.

When the contingent liability matures and the buyer pays it, there are two theoretical ways to treat this payment for tax purposes. The buyer might deduct the payment currently, or she might include the payment in the basis of the assets acquired. Although most buyers would prefer to take the deduction,⁶⁷ case authority has consistently held that the buyer must include the payment in the cost basis.⁶⁸

This rule can be justified on the following grounds. First, a taxpayer is not entitled to deduct her payment of another's expenses.⁶⁹ In paying the contingent liability, the buyer is paying the *seller's* business expense. More importantly, the buyer did not incur the liability in her operation of a business; rather, she incurred it as part of the consideration paid for assets. Accordingly, the payment should be included in the basis of those assets.⁷⁰ Nothing in the nature of contingent liabilities justifies a treatment different from that of fixed liabilities.⁷¹

Once again referring to our example for illustration, the buyer paid \$850,000 for a business whose assets, goodwill, and going concern value had a fair market value of \$1,000,000. The parties agreed to the lower price in consideration of the \$150,000 contingent liability the buyer agreed to assume. In effect, once the buyer pays the liability, she has paid the full \$1,000,000 value for the business; thus, her cost basis should include this payment.

One might argue against including the buyer's payment in her basis by pointing to the treatment of contingent liabilities in nontaxable acquisitions of

67. By claiming the deduction, the taxpayer would receive an immediate tax benefit in the form of an offset against income. If the payment is added to the cost basis of the asset, the taxpayer would not receive the benefit until the asset is sold. Thus, the buyer should prefer to claim an immediate deduction to take advantage of the time value of money.

68. *E.g.*, *W.D. Haden Co. v. Commissioner*, 165 F.2d 588 (5th Cir. 1948) (buyer's payment of seller's tax deficiency that matured subsequent to sale); *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946) (buyer's assumption of seller's liability on a pending personal injury suit); *Athol Mfg. Co. v. Commissioner*, 54 F.2d 230 (1st Cir. 1931) (buyer's assumption of all of seller's liabilities, whether actual or contingent); *Automatic Sprinkler Co. v. Commissioner*, 27 B.T.A. 160 (1932) (assumption of all of seller's liabilities, whether actual or contingent). Only one case apparently indicates that a business expense deduction would be proper. In *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831 (1963), the Tax Court stated, in dicta, that where the buyer pays the contingent liability, she may claim a deduction in the year of payment. *Id.* at 839. Given that this statement was made in dicta, and in view of the overwhelming authority to the contrary, taxpayers should not rely on *Albany Wheel* to claim deductions.

69. See *supra* note 36 and accompanying text.

70. *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982) (stating that "an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset"), *cert. denied*, 463 U.S. 1207 (1983).

71. Comment, *supra* note 22, at 87. The author explained:

When the vendee assumes fixed liabilities, they are treated as part of his capital investment. Upon payment of these liabilities, the vendee is not entitled to a business deduction. . . . The vendee is not permitted to deduct any other item included in the price of the business as an expense, and he should not be permitted to do so when the capital investment is disguised in the form of a contingent liability.

Id. at 87-88.

assets.⁷² In these cases, the buyer is permitted to deduct the cost of the seller's contingent liabilities that mature after acquisition.⁷³ However, this situation can be distinguished from taxable acquisitions. In the tax-free acquisition, the buyer takes an exchanged basis equal to her basis in the consideration she has given.⁷⁴ Essentially, the Internal Revenue Code ("Code") deems the buyer to be continuing the seller's business, thus, entitling her to use of the seller's business deductions.⁷⁵ In contrast, the buyer in a taxable acquisition is not entitled to use the seller's business expense deductions because the new owner is not deemed to be "continuing" the business.⁷⁶ Consequently, the situation involving nontaxable acquisitions is sufficiently distinguishable from a taxable acquisition of a business and a different treatment of contingent liabilities properly applies.

Since current law requires the buyer to include this payment of liability in the basis of the assets acquired, her next concern is how to do so. Treasury regulations under section 1060 govern this situation.⁷⁷ Essentially, the regulations require the buyer to allocate, by use of the residual method, the contingent liability payment among the assets acquired.⁷⁸ The residual method requires the additional payment to be allocated first to all identifiable assets to the extent of those assets' fair market value.⁷⁹ Any value remaining will be allocated to goodwill and going concern value.⁸⁰

An example will assist in explaining the allocation under the residual method. Under the example, the buyer will ultimately pay \$150,000 to satisfy the contingent liability she has assumed. Thus, \$150,000 is the amount of additional consideration which must now be allocated among the acquired assets. The \$150,000 will first be assigned to any certificates of deposit, United States government securities, readily marketable stock or securities, and foreign currency which the buyer acquires from the seller.⁸¹ Any amounts remaining after this assignment will be allocated to all tangible and intangible assets ac-

72. See I.R.C. §§ 361, 368 (1988).

73. *Id.* § 381(c)(16).

74. *Id.* § 358.

75. *Id.* § 381(c)(16). This Code section provides:

If the acquiring corporation—

(A) assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and

(B) such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income, the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation.

Id.

76. See *supra* notes 69-71 and accompanying text.

77. See Treas. Reg. § 1.1060-1T(f) (1988).

78. *Id.*

79. *Id.* § 1.1060-1T(d).

80. *Id.*

81. *Id.*

quired, *other than* goodwill and going concern value.⁸² Finally, any amounts remaining after the allocation to these tangibles and intangibles will be allocated to goodwill/going concern value.⁸³

In most cases, the practical result of allocation under the residual method will be that the contingent liability payment will be allocated to goodwill/going concern value. This is because the section 1060 regulations limit the amount of the purchase price that can be allocated to any particular asset to the asset's fair market value on the date of sale.⁸⁴ In most cases, this limit will be reached upon the buyer's initial payment. Any additional amounts paid—that is, the buyer's subsequent payment of the contingent liability—would have to be allocated to goodwill/going concern value.⁸⁵

A complication in allocating the payment arises where the liability is paid after the buyer has sold or depreciated some of the assets acquired. In these cases, the section 1060 regulations provide that the portion of the payment otherwise allocable to the asset shall be taken account of under "applicable principles of tax law."⁸⁶ The section 1060 regulations give no further guidance. Fortunately, the regulations under section 338 of the Code do provide guidance.⁸⁷ These regulations provide that where the asset has been depreciated, the additional basis resulting from the reallocation is simply added to the basis of the asset.⁸⁸ Where the asset has been sold, the additional amount of basis

82. *Id.*

83. *Id.*

84. *Id.* § 1.1060-1T(e).

85. Section 1060 and the regulations promulgated thereunder are an attempt to eliminate the practice of purchasers over allocating amounts of the purchase price to depreciable assets. The primary reason for such allocation was that goodwill and going concern value cannot be depreciated. Treas. Reg. § 1.167(a)-3 (1986) ("No deduction for depreciation is allowable with respect to goodwill."). *VGS Corp. v. Commissioner*, 68 T.C. 563, 591, 592 (1977), *acq.* 1979-1 C.B. 1 (going concern value is not depreciable separately nor as an enhancement to depreciable assets). Goodwill has been defined by the Fifth Circuit as "the advantage or benefit acquired by an establishment . . . [as a result of] general public patronage and encouragement which it receives from constant or habitual customers because of local position, common celebrity, reputation for skill, influence, or punctuality or from other accidental circumstances or even from ancient partialities or prejudices." *Masquelette's Estate v. Commissioner*, 239 F.2d 322, 325-26 (5th Cir. 1956). Going concern value is the element of value attaching to property due to its being part of an operating enterprise. *VGS Corp.*, 68 T.C. at 591. Consequently, buyers attempted to allocate the maximum amount of the purchase price to depreciable assets, even if such allocation overstated the worth of such assets and detracted from the amount actually paid for the goodwill and going concern value. Section 1060 and the regulations remedy this abuse, by limiting the amount of purchase price which may be allocated to an asset to the asset's fair market value on the date the business is sold to the buyer. Treas. Reg. § 1.1060-1T(e) (1990).

86. Treas. Reg. § 1.1060-1T(f) (1988).

87. See Temp. Treas. Reg. § 1.338(b)-3T (1988). These regulations should still have authoritative effect under § 1060, notwithstanding the recent enactment of the § 1060 regulations. This is because the allocation method to be used under § 1060 is identical to that provided in the regulations under § 338 for allocating purchase price to assets following a stock purchase. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 208, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4296, 4297.

88. Temp. Treas. Reg. § 1.338(b)-3T (1988).

allocable to the asset will be treated as a capital loss under the principles of *Arrowsmith v. Commissioner*.⁸⁹

b. Impact upon the seller

The buyer's payment of the liability will result in additional income to the seller at the time of payment. This result is compelled by traditional tax principles. Generally, the value of an assumed fixed liability is included in the seller's amount realized.⁹⁰ As contingent liabilities cannot be valued for tax purposes at the time of sale,⁹¹ the seller's additional amount of realized income can be quantified only when the liability is paid by the buyer.

When the contingent liability is paid and this payment is realized as income by the seller, uncertainty exists as to how this realized income should be reported. This question is complicated further in that payment of the liability could occur years after the original sales transaction.

One possible solution for the seller in this instance would be to report the additional amount realized under the open transaction doctrine of *Burnet v. Logan*.⁹² In *Burnet*, the taxpayers sold their stock in an iron company for cash and the purchaser's promise to pay the seller sixty cents for each ton of ore obtained from a mine leased by the company.⁹³ Since it was uncertain whether any additional amounts of ore would be extracted, the taxpayers argued that the purchaser's promise to pay sixty cents per ton was too uncertain to be valued and included in the amount realized at the time of sale.⁹⁴ The Supreme Court accepted the taxpayer's position.⁹⁵ The Court applied the "open transaction doctrine," whereby the subsequent purchase payments would constitute income to the taxpayer only to the extent the payments exceeded the taxpayer's basis in the stock.⁹⁶ In other words, only payments received after the basis had been exhausted would constitute income to the taxpayer.⁹⁷ If the seller in our example used the *Burnet* rule, he would report the additional

89. 344 U.S. 6 (1952); see *supra* note 41 and accompanying text.

90. *Smith v. Commissioner*, 324 F.2d 725, 726 (9th Cir. 1963) (treating the assumption of the taxpayer's obligations by a third party as money received by the taxpayer); *Curran v. Commissioner*, 47 T.C.M. (CCH) 1160, 1167-68 (1984) (sale of an interest in a partnership in exchange for a promissory note and the assumption of the seller's partnership liabilities resulted in capital gain for seller); Treas. Reg. § 1.1001-2 (1988) (amount realized on the sale of property "includes the amount of liabilities from which the transferor is discharged as a result of the sale").

91. See *supra* notes 65-66 and accompanying text; see also *Gibson Prods. Co. v. United States*, 460 F. Supp. 1109, 1116-17 (N.D. Tex. 1978) (taxpayer was not entitled to increase the basis of its partnership interest for its share of nonrecourse liability because that liability was contingent), *aff'd*, 637 F.2d 1041 (5th Cir. 1981); *Freitas v. Commissioner*, 25 T.C.M. (CCH) 545, 556 (1966) (contingent liability of the stockholders was too remote and indefinite to be taken account of in computing their gain on the sale of stock).

92. 283 U.S. 404 (1931).

93. *Id.* at 412.

94. *Id.*

95. *Id.*

96. *Id.* at 413-14.

97. *Id.*

amount realized only to the extent that it exceeded his basis in the assets. This additional amount realized would then be apportioned between ordinary and capital gain.⁹⁸

Contrast the result under the open transaction doctrine with the case where the transaction is considered closed at the time of the initial payment. The seller's amount realized, and the amount of gain to be designated as ordinary or capital, is also set. Thus, under the closed transaction scenario, the buyer's subsequent postclosing payment of the liability would constitute *ordinary* income to the seller.⁹⁹ Moreover, the seller will lose the benefit of any basis not used to offset his gain on the transaction. Therefore, it is to the seller's advantage to assert open transaction treatment, due to the fact that the amount realized is limited to the extent that the aggregate of the payments received exceeds his basis and this excess will be characterized as capital gain, as opposed to ordinary income. Since he is able to enjoy the full benefit of this basis and capital gain treatment on his amount realized, he will incur less income tax on the sale.

2. Use of an Escrow to Satisfy the Contingent Liability

Under this arrangement, the buyer will deposit a portion of the purchase price into escrow. The deposited funds will be used to satisfy contingent liabilities which mature during the existence of the escrow. When the escrow terminates, any funds remaining in the account will be delivered to the seller.

Referring to the example, the buyer will pay \$850,000 to the seller at closing and place \$150,000 into escrow. Assume the parties have agreed that the escrow will exist for three years. Also assume that two years after the sale, judgment is rendered in favor of the plaintiff in the amount of \$150,000. The \$150,000 in escrowed funds is used to pay the judgment. At the end of the escrow period, no funds are paid to the seller because the entire escrowed amount was used to pay the contingent liability.

a. Impact upon the buyer

Current law requires a buyer who pays a seller's contingent liability to include this payment in the basis of the assets acquired.¹⁰⁰ Normally, this inclu-

98. *Williams v. McGowan*, 152 F.2d 570, 571-72 (2d Cir. 1945) (sale of a business as a going concern to be treated as a sale of individual assets with resulting apportionment of the amount realized between capital and ordinary gain).

99. A discharge of indebtedness constitutes income to the party so discharged. I.R.C. § 61(a)(12) (1988). This income would have to be characterized as ordinary, as it is not associated with a disposition of a capital asset due to the previous transaction—the sale of assets—being deemed closed. *See id.* § 1221 (capital asset defined). Currently, capital gain income is taxed at a maximum rate of 28%; thus, still enjoying some preferential treatment, although nothing near that accorded capital gain income prior to the Tax Reform Act of 1986. *See Revenue Reconciliation Act of 1990*, Pub. L. No. 101-508, § 11101, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS (104 Stat.) 1388.

100. *See supra* note 68 and accompanying text.

sion cannot be effected until the liability is actually paid.¹⁰¹ The escrow device, however, permits the buyer to include the cost of the liability in basis at the time funds are deposited. By delivering the funds in escrow, the buyer has irrevocably parted with the funds.¹⁰² Escrowed amounts ultimately delivered to the seller would be included in the buyer's cost basis.¹⁰³ Alternatively, any amounts used to satisfy the contingent liability would also be included in the buyer's cost basis.¹⁰⁴ Since one of these alternatives must result, the buyer will increase her cost basis at the time of deposit.¹⁰⁵ The purchase price and, hence, the buyer's cost basis, has been definitely fixed at this point. Moreover, since the buyer has irrevocably parted with the funds, she has definitely incurred a cost and, accordingly, the traditional justifications against including a contingent liability in cost basis do not apply.¹⁰⁶ Thus, use of the escrow provides the buyer with the advantage of including the contingent liability in her cost basis at the time of sale, rather than at the time of the payment of the liability.¹⁰⁷ This advantage is not available where the buyer assumes the contingent liability outright.¹⁰⁸

b. Impact upon the seller

The tax issue facing the seller in the escrow arrangements is *when* he will include the escrowed funds in his amount realized.¹⁰⁹ The seller should include

101. See *supra* notes 65-68 and accompanying text.

102. This assumes, of course, that the escrow agreement denies the buyer the right to withdraw the funds and does not provide for the return of the funds to the buyer.

103. Treas. Reg. § 1.1001-1 (1957).

104. See *supra* note 68 and accompanying text.

105. Comment, *supra* note 22, at 92.

106. See *supra* notes 45-47 and accompanying text.

107. Including the amount of payment in the basis of the assets at the time of the sale, instead of at the time of payment of the liability, is advantageous because the buyer can immediately claim higher depreciation deductions (which are directly correlated to the basis in the assets). See I.R.C. § 167(g) (1988).

108. See *supra* notes 65-68 and accompanying text.

109. Prior to 1980, an additional issue for sellers using the escrow technique was whether use of the escrow would preclude use of the installment method of reporting income. The Internal Revenue Code defines the installment method as "a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price." I.R.C. § 453(c) (1988).

Before 1980, if the escrowed amount exceeded 30% of the purchase price, use of the installment method was precluded. S. REP. No. 1000, 96th Cong., 2d. Sess. 10, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 4696, 4704. By eliminating the 30% requirement, Congress removed this impediment to using the installment method. *Id.*

Additionally, under the doctrine established in *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972), the installment method was not available if the selling price was not fixed and determinable. *Id.* at 1159-60. Congress preempted case law such as *Gralapp* in 1980, by instructing the Treasury Department to enact regulations permitting use of the installment method where the selling price is contingent. See I.R.C. § 453(j)(2) (1988). The IRS has since enacted these regulations. See Treas. Reg. § 15.453-1(T) (1981).

the entire escrowed amount in his amount realized at the time the buyer deposits the funds in escrow.¹¹⁰ This result is proper because only one of two uses may be made of the escrowed funds: the seller will obtain the funds directly, or he will be relieved of the contingent liability. Either disposition of the funds will result in an increase in the seller's amount realized.¹¹¹ Accordingly, the seller should include the escrowed funds in his amount realized when the buyer irrevocably parts with the funds by placing them in escrow.¹¹²

3. Buyer Withholds a Portion of the Purchase Price

Under this arrangement, the buyer will withhold an amount of the purchase price for a set period. Any contingent liabilities that mature during this period will be paid by the buyer with the withheld funds. Any funds remaining at the end of this period will be paid over to the seller. Referring to the example, the buyer will withhold \$150,000 for three years. Two years later, when judgment is rendered, the buyer will pay \$150,000 to the plaintiff. At the end of the third year, no funds are paid to the seller because the entire amount withheld was used to pay the contingent liability. Practically, this arrangement works in much the same way as the escrow, except that the money is held by the buyer

Application of the installment sales regulation hinges upon a finding of the maximum selling price. *Id.* The maximum selling price in the case of the escrow would be the sum of the escrowed amount and all other payments. In these contingent payment sales, the seller's basis will be allocated between payments received and to be received. *Id.* Thus, each payment (including payments of contingent liabilities) would result in some amount of taxable gain to the seller.

110. See *Steckel v. Commissioner*, 26 T.C. 600 (1956), *aff'd*, 253 F.2d 267 (6th Cir. 1958). In *Steckel*, the taxpayer, Steckel, was sued by his attorneys for payment due for services rendered. At the time of the attorneys' suit, Steckel sold stock he owned. *Id.* at 603. The district court ordered the buyer of this stock to deposit \$225,000 of the stock purchase price with the clerk of the district court. The clerk was to hold this amount pending determination of the attorneys' suit against Steckel. Eventually, \$190,355.87 was paid to the attorneys. The Tax Court found that Steckel realized income *at the time the funds were deposited with the clerk* because the funds would either be paid directly to Steckel or be used to discharge his debt for attorneys' fees. *Id.* at 604 (emphasis added). In either event, Steckel would realize income. The court noted that "the realization of gain on the disposition of stock is not to be deferred solely because the proceeds are deposited with a third party who will ultimately either pay the money to the taxpayer or use the money to discharge the taxpayer's lawful debt." *Id.* at 609.

111. See *supra* note 90 and accompanying text.

112. A related issue is which party should be taxed on the accumulated interest on the escrowed funds. It appears that the interest earned on the escrowed funds must be taxed to the buyer. If the interest is paid to the buyer directly, then the payment constitutes income to her under the Code. See I.R.C. § 61(a)(4) (1988). Moreover, the Code directs the IRS to promulgate regulations governing the taxation of escrow accounts, settlement funds or similar funds. *Id.* § 468B(g). Where the income of the escrow is used to discharge a legal obligation of the transferor (the buyer places money into the escrow) then that income is currently taxable to the transferor. S. REP. NO. 445, 100th Cong., 2d Sess., *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 4908. Under the asset purchase agreement, the buyer has assumed the contingent liability. Thus, this liability has become her legal obligation. She may agree to discharge this liability by use of the funds transferred into escrow. If the interest on these funds is used to discharge the liability, then a legal obligation of the transferor has been discharged by use of the interest and the Code apparently mandates that the buyer be taxed on this interest. See I.R.C. § 468B(b)(1) (1988).

rather than in escrow. Many of the same tax concerns found in the escrow agreement also arise here.

a. Impact on the buyer

As with the escrow arrangement, the buyer should include the amount of the withheld funds in her cost basis at the time of sale.¹¹³ The amount of the funds withheld is definitely fixed. Moreover, the buyer has incurred a definite obligation to pay this fixed amount to the seller or to use the funds to satisfy the contingent liability. In either event, an increase in the buyer's basis will result.¹¹⁴ As the purchase agreement obligates the buyer to make these payments, the buyer should include the amount withheld in basis at this time.¹¹⁵

b. Impact on the seller

The tax consequences to the seller under this arrangement will hinge upon the seller's accounting method. Where the seller uses the accrual basis of accounting,¹¹⁶ he will recognize the entire amount withheld upon closing.¹¹⁷

A different rule applies where the seller is on a cash basis. The cash basis seller normally does not recognize income until he actually receives the funds.¹¹⁸ An exception to this rule exists where the buyer's obligation has an ascertainable fair market value and is readily convertible into cash. In these cases, the cash basis seller will recognize the *fair market value* (not necessarily the face value) of the obligation as income at the time of sale.¹¹⁹ For example, where the buyer tenders a transferable promissory note with a fair market value of \$100,000, the seller will realize the \$100,000 as income at that point. This exception does not apply where the buyer's obligation has no ascertainable fair market value¹²⁰ or is not readily transferable.¹²¹ In these

113. See *supra* notes 100-08 and accompanying text.

114. Comment, *supra* note 22, at 92.

115. *Hollywood, Inc. v. Commissioner*, 10 T.C. 175 (1948) (basis in property includes amount buyer is obligated to pay in the future).

116. "The basic idea under the accrual system is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned regardless of whether payment has been made as is due." *H.H. Brown Co.*, 8 B.T.A. 112 (1927).

117. Treas. Reg. § 1.451-1 (1957) ("Under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.").

The seller's right to receive income is fixed in this instance, since he will either receive the income directly if the contingency does not mature in three years, or the buyer will satisfy the seller's liability out of the withheld funds. This latter possibility is also considered income to the seller. See *supra* note 91 and accompanying text.

118. Treas. Reg. § 1.451-1 (1957). ("Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received.").

119. See *Hurlburt v. Commissioner*, 25 T.C. 1286, 1289 (1956), *nonacq.*, 1956-2 C.B. 10.

120. *Id.* at 1288 (cash basis seller did not immediately realize the buyer's promise as income because the promise could not be valued); see *Hexter v. Commissioner*, 8 B.T.A. 888 (1927) (holding that whether a receipt of property constitutes a taxable gain is dependent on whether

cases, the cash basis seller will recognize income only as the buyer makes actual payments.

In the example we have been using, the buyer withholds \$150,000, payable to the seller only if the contingent liability does not mature within three years. Given this uncertainty, the rule that income is recognized only when funds are received should apply to this situation; the exception for obligations that have an ascertainable fair market value and are readily convertible into cash is inapplicable. For the cash basis seller, the argument goes as follows: in the withholding arrangement, the buyer's obligation has no ascertainable fair market value, nor is it readily convertible into cash. Due to the possible set-off resulting from payment of the contingent liability, the fair market value of the obligation cannot be determined. The seller would also contest whether this type of obligation is even marketable or "readily transferable" given the hypothetical transferee's reluctance to accept a note on which it might ultimately recover nothing.¹²² Finally, the cash basis seller should point out that a buyer's contractual promise, standing alone, is inherently unmarketable.¹²³ Thus, the cash basis seller should not include the withheld funds in his amount realized until the liability is actually paid, or the funds are actually distributed to him.

III. CONCLUSION

Before the parties adopt a particular treatment of the seller's contingent liability, they must review the tax consequences resulting from the treatments of these liabilities. Once again, these treatments, and their attendant tax consequences, are:

1. Seller retains the contingent liability and pays it when it matures.
 - a) Seller is a:
 - (i) sole proprietor: Provided the contingent liability is otherwise deductible,

such property has a market value at that time; if it has no market value when received, no taxable gain results from its receipt).

121. *McIntosh v. Commissioner*, 26 T.C.M. 1164 (1967) (seller's receipt of a buyer's nonnegotiable notes did not constitute income); *Ennis v. Commissioner*, 17 T.C. 465 (1951) (seller's receipt of the buyer's nontransferable promise did not constitute income).

122. *Ennis*, 17 T.C. at 470 ("[T]he requirement has always been that the obligation, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce.").

123. *Id.* (mere contractual promise, without other evidence of indebtedness such as a note, held unmarketable); see *Johnston v. Commissioner*, 14 T.C. 560 (1950). In *Johnston*, the Tax Court explained:

However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to . . . the seller if he is using a cash system.

Id. at 565.

the sole proprietor obtains a business expense deduction.¹²⁴

(ii) former shareholder of corporate seller: The shareholder paying the corporation's contingent liability after the corporation liquidates is entitled to claim a capital loss deduction.¹²⁵

b) Buyer: The seller's payment of his own contingent liability should have no income tax impact upon the buyer.¹²⁶

2. Indemnity clause given by seller to buyer.

a) Seller: Buyer's initial payment of the liability does not constitute income to the seller as buyer's payment here is essentially a loan to the seller. Seller is entitled to either a business expense deduction or a capital loss deduction for his reimbursement of the buyer.¹²⁷

b) Buyer: Upon the initial payment of the liability, the buyer acquires a claim against the seller. The buyer's basis in the claim is increased by the amount she expended in paying the liability. When the seller reimburses the buyer, the buyer will realize income only to the extent that the reimbursement exceeds her basis in the claim. Should the seller be unable to reimburse, the buyer will be entitled to deduct the resulting bad debt as a short-term capital loss.¹²⁸

3. Buyer assumes the contingent liability and pays it when it matures.

a) Buyer: Only when the buyer pays the contingent liability may she include it in the basis of the assets acquired.¹²⁹

b) Seller: When the buyer pays the contingent liability, the seller will include this payment in his amount realized on the sale of the assets.¹³⁰

4. Buyer assumes the contingent liability by use of escrow.

a) Buyer: The buyer will include the amount of the escrowed funds in her cost basis of the assets acquired at the time she deposits the funds into escrow.¹³¹

b) Seller: The seller will include the amount of the escrowed funds in his amount realized at the time the buyer places these funds in escrow.¹³²

5. Buyer withholds funds with which to pay the contingent liability.

a) Buyer: The buyer should include the amount of the withheld funds in her cost basis at the time of closing.¹³³

b) Seller: The accrual basis seller will include the amount of the withheld funds in his amount realized upon closing. The cash basis seller should not include the withheld funds in his amount realized until the liability is actually

124. See *supra* notes 27-34 and accompanying text.

125. See *supra* notes 35-44 and accompanying text.

126. See *supra* notes 45-47 and accompanying text.

127. See *supra* notes 48-50 and accompanying text.

128. See *supra* notes 51-64 and accompanying text.

129. See *supra* notes 65-89 and accompanying text.

130. See *supra* notes 90-99 and accompanying text.

131. See *supra* notes 100-08 and accompanying text.

132. See *supra* notes 109-12 and accompanying text.

133. See *supra* notes 113-15 and accompanying text.

paid or the funds are actually distributed to him.¹³⁴

Depending upon the dollar amounts and other factors involved, the issue of the treatment of the seller's contingent liabilities could prove to be a major point of contention in an asset sale. Such considerations are fact specific and, therefore, beyond the scope of this Article. In determining the disposition of a contingent liability, however, the parties should be aware of the tax benefits gained or lost. This Article discusses the current state of tax law regarding contingent liabilities, and provides counsel in this regard.

134. See *supra* notes 116-23 and accompanying text.

