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Insights Into Recent Regulatory, Judicial and Legislative Developments

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Buying a Business That Has Deferred Income

Reg. 1.1502-80(g)

Nature of the Problem

Although deferral of reporting of income that has been received is uncommon, the option is allowed to many businesses under rules such as section 455 for prepaid subscription income. When the assets of such a business are sold in a taxable transaction, the buyer will often have to assume the contractual obligation for which the seller has already paid. (Assume the seller does not transfer to the buyer any fund or deposit representing the prepaid income.)

Usually the amount and timing of the cost of performing such an obligation are uncertain and contingent. When the buyer of a business assumes a contingent liability of the seller, it usually cannot add the cost of such liability assumption to the basis of the assets purchased until the liability becomes fixed, even if the buyer is able to reasonably estimate the amount that it will eventually have to spend to perform the obligation. Even though the cost of the performance (such as payroll) would otherwise be deductible by the buyer in the normal course of its business, based on these facts, such costs may have to be capitalized as an adjustment to the basis of assets bought.

The buyer will view this treatment as a problem. The buyer will feel that it has "paid" the value it attributed to the assumed contracts as additional purchase price at the time of purchase of the business. The buyer may know the amount of the seller's deferred income and may feel that that is the amount it has assumed, and that therefore it is the amount by which the basis of purchased assets should be increased.

Solutions

Viewing the case only from the buyer's side, there is a range of possible treatments: (1) "step in the shoes," meaning the buyer assumed no liability and will simply pay and deduct its own expenses in the future as they accrue; (2) noncontingent liability assumption, meaning that the buyer can quantify and capitalize the liability assumption immediately into the assets bought; or (3) contingent liability assumption, meaning the cost of performance is capitalized when paid or accrued. As indicated, depending on the facts, it is likely solution (1) will not be possible where the buyer does contractually assume performance obligations, and solution (2) will not be possible because the cost of performing the obligation is truly contingent. That leaves (3) as the normal outcome.

One way to contain the downside of solution (3) is to limit the portion of the buyer's future operating costs that are attributable to the performance of the assumed contracts. The buyer normally prefers to deduct operating costs currently, rather than capitalizing them into the basis of the acquired assets. If costs have to be capitalized into depreciable or amortizable assets, the buyer will normally be able to depreciate or amortize those costs. But capitalized costs of performance will not otherwise include depreciation or amortization of the acquired assets. The basis of the acquired assets will be no more that the fixed liabilities, plus the contingent liabilities when they become fixed, and there is no additional basis to amortize or depreciate.

The Bigger Problem

Although the buyer may not be completely satisfied with the solution (3) described above, it is considerably better than the treatment arguably implied by Reg. 1.1502-80(g)(2), adopted in 2008. That regulation would appear to be unrelated to this issue, but it reached out to discuss the liquidation of a corporation with deferred prepaid subscription income in Example 3. The consolidated return issue stemmed from the fact that multiple group members owned the stock of a liquidating member. When the 20 percent shareholder received the assets and assumed the obligation to perform the business as to which the liquidating member had deferred prepaid income, “any income” that 20 percent shareholder “realizes on account of consideration received (or deemed received) on its assumption of X’s liability to furnish or deliver the newspaper, magazine, or other periodical to which the prepaid subscription income relates” is not protected from recognition by section 332.

What is “any income” and why is anything “deemed received”? Subsection (g)(2) refers to “any income realized by the distributee member under applicable principles of law on account of consideration received (or deemed received) on the assumption of the liquidating corporation’s obligation or liability attributable to any deferred income item.” Neither the regulation’s preamble nor the notice of proposed rulemaking explained what is going on. However, it is pretty clear that the regulation is referring to an “applicable principle of law” reflected in *Pierce v. CIR*, 326 F. 2d 67 (8th Cir. 1964), which ruled that a seller with deferred subscription income had to take the deferral into income, but was allowed a deduction for some “payment” to the buyer to deliver the magazines. The case did not involve the buyer’s treatment. Rev. Rul. 71-450, 1971-2 C.B. 78, however, ruled that a buyer had income in a similar case where the contract stated that the seller was paying the buyer a fixed amount for assuming the obligations.

No such contract term was mentioned in the example in the regulation, and in the absence of such contract term, the reference to “any income” presumably meant none. However, the regulation unfortunately increases concern about an income inclusion for a buyer in such cases. *If* there could be an income inclusion without a contractual payment by the seller for the assumption, it would in theory be the amount the seller was deemed to pay, which the buyer ordinarily has no way of knowing, except to impute it from the value of the assumption of the contingent liability—which certainly is not necessarily the same as the seller’s deferred income.

Only if the property acquired is worth measurably more than the amount paid in cash should the buyer even theoretically be in receipt of a payment—and in such case, if the buyer takes the payment into income, the buyer should obtain basis in the property bought in that additional amount. This may relieve the buyer from having to later capitalize a portion of its expenses of performance, which could result in a net benefit if the value of the assumption is found to be small.

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