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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
SPECIAL TRIAL COUNSEL

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel CC:CORP

SUBJECT: Whether Purchaser is entitled to a deduction for contingent liabilities of a Target Corporation, which liabilities were paid by the Seller after the Target was acquired in a Section 338(h)(10) transaction, when the liabilities were paid.

This Field Service Advice responds to your memorandum dated May 3, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Taxpayer -

Seller -

Purchaser -

Target -

Date A -

Date B -

Date C -

Date D -

Date E -

Date F -

Year 1 -

Year 2 -

Amount 1 -

Amount 2 -

State -

ISSUES:

(1) Whether Taxpayer is entitled to deduct on the acquiring group's consolidated return contingent liabilities that Target accrued prior to its acquisition, which were paid by the Seller pursuant to an indemnity agreement entered into in connection with a stock purchase qualifying under Code § 338(h)(10).

(2) Whether Taxpayer is entitled to deduct interest accruing on Target's contingent liabilities, such interest having been paid by the Seller pursuant to the indemnity agreement.

(3) How should Purchaser treat various amounts (i.e., accrued State franchise taxes and pre- and post-acquisition interest accruing on such liability) paid by Seller pursuant to the indemnity agreement.

CONCLUSIONS:

(1) Taxpayer is not entitled to a deduction for contingent liabilities that Target accrued prior to its purchase even though such liabilities were paid by the Seller pursuant to an indemnity agreement entered into in connection with a stock purchase qualifying under Section 338(h)(10).

(2) Taxpayer is not entitled to a deduction for interest which accrued on Target's contingent liabilities ("pre-acquisition interest") during the period prior to Target's acquisition. Taxpayer is entitled to a deduction for interest which accrued on Target's contingent liabilities for the period after Target's acquisition, even though such interest was paid by the Seller pursuant to an indemnity agreement entered into in connection with a stock purchase qualifying under Section 338(h)(10).

(3) New Target is treated as the deemed purchaser and therefore is deemed to have assumed on the acquisition date Old Target's contingent liabilities and the pre-acquisition interest accruing on such liabilities. New Target gets an upward adjustment in the basis of its assets in the amount of the contingent liabilities and pre-acquisition interest which it assumed only when the contingent liabilities and pre-acquisition interest become fixed and determinable. New Target also gets an offsetting downward adjustment in the basis of its assets in the amount of the contingent liabilities and pre-acquisition interest accruing on such liabilities in the amounts paid by the Seller only as of Dates C and D, the dates on which the Seller made the payments. New Target is not deemed to have assumed the interest accruing on these contingent liabilities in the period after Target's acquisition ("post-acquisition interest"). Accordingly, New Target may not make an upward adjustment in the basis of its assets by the amount of the post-acquisition interest accruing on the contingent State franchise tax liabilities. Even though it does not get to make an upward adjustment in the basis of its assets in the amount of such post-acquisition interest, New Target nevertheless must reduce its basis in its assets by the amount of post-acquisition interest paid by Seller pursuant to the indemnity agreement entered into in connection with a stock purchase.

FACTS: On Date A, Purchaser, a domestic corporation, entered into a stock purchase agreement with Seller, the common parent of the selling consolidated group in which Target used to be a member. Pursuant to the stock purchase agreement, Purchaser agreed to purchase Target and Target's subsidiaries. At the time of this agreement, Target was wholly owned by Seller. Acting pursuant to the stock purchase agreement, the parties made a valid election under I.R.C. § 338(h)(10), to treat the stock purchase as a deemed asset purchase.

In connection with Target's purchase, Seller and Purchaser entered into a Tax Agreement in which Seller agreed to pay, be liable for, and indemnify Purchaser, Target and Target's subsidiaries for any and all taxes imposed on Target and/or Target's subsidiaries for taxable years ending on and before the closing date of the sale. No provision in this Tax Agreement specifically mentions who would be responsible to pay for interest arising as a result of any pre-acquisition tax liabilities accrued by Target and its subsidiaries.

Two months prior to Date B (the closing date), State taxing authorities issued proposed notices of deficiency against Target with regard to Target's taxable Year 1

through Year 2 for unpaid State franchise taxes. Purchaser acquired Target on or around Date B. Seller settled with State concerning the unpaid franchise taxes and interest accruing on such taxes on Date F. On Dates C and D, Seller paid Amount 1 in State franchise tax liabilities and Amount 2 in interest which had accrued on such liabilities. Seller paid these amounts in accordance with the indemnification provision of the tax agreement.

Taxpayer, the common parent of the acquiring group (the consolidated group of which Target is currently a member), deducted Amount 1 for state taxes and Amount 2 for interest (i.e., the same amounts Seller paid with regard to Target's State franchise tax liabilities and the interest accruing thereon) on the acquiring group's consolidated tax return for the year ending Date E. In deducting these amounts, Taxpayer is claiming that New Target is entitled to deduct the liabilities that Old Target accrued prior to being acquired that were subsequently paid by Seller pursuant to the indemnity agreement entered into in connection with the stock purchase agreement.

LAW AND ANALYSIS: For purposes of this section of this advice, Target may be referred to as Old Target for periods ending as of the close of Date B. Target may be referred to as New Target for the period beginning as of the day after Date B. See Temp. Reg. § 1.338-1T(b)(7).

A. The Contingent State Franchise Tax Liabilities

Under general principles of tax law, an acquiror corporation may not deduct accrued liabilities of a target corporation in the year of purchase or at any other time. Costs incurred in the acquisition of a capital asset are not ordinary and necessary expenses but rather are capital expenditures. Woodward v. Commissioner, 397 U.S. 572 (1970); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); Perlmutter v. Commissioner, 44 T.C. 382 (1965), aff'd 373 F.2d 45 (10th Cir. 1967).

The acquiror must capitalize payments made on such assumed liabilities and add them to the basis of the acquired assets. Magruder v. Supple, 316 U.S. 394, 398 (1941); David P. Webb Company, Inc. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983); Pacific Transport Company v. Commissioner, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974); Portland Gasoline Company v. Commissioner, 181 F.2d 538 (5th Cir. 1950); Rev. Rul. 76-520, 1976-2 C.B. 42. A digest of these cases and the Service pronouncement is set forth below.

In Magruder v. Supple, both the purchaser and the seller of land agreed to apportion Maryland real estate taxes ratably over their respective periods of ownership. The purchaser claimed a deduction for state real estate taxes arising as a result of the fractional part of the year of purchase apportioned to it. The U.S. Supreme Court

denied the purchaser the deduction because the taxes had already accrued and a lien had been placed against the seller prior to the sale. The Court reasoned that “[p]ayment of a liability by a subsequent purchaser is not the discharge of a burden which the law has placed upon him, but is actually as well as theoretically a payment of the purchase price” 316 U.S. at 398.

In David P. Webb Company, the taxpayer purchased the assets of a business in 1972. In the years prior to the purchase, the business had entered into an employment agreement with an employee-shareholder providing that, if he died while still an employee, his widow would be entitled to a lifetime pension. The shareholder died in 1952 and, from 1953 through 1966, the corporation made and deducted the annual pension payments. The assets of the corporation were sold in 1966, again in 1969, and finally all sold to the taxpayer in 1972. In each sale, the pension liability was expressly assumed by the purchaser. The court disallowed the taxpayer's deduction of the pension payments and held that these costs should be capitalized and added to the basis of the acquired property.

In Pacific Transport, the court held that a payment made by a parent corporation in discharge of a contested liability, first asserted against a subsidiary and assumed by the parent upon liquidation of the subsidiary under I.R.C. §§ 332 and 334(b)(2), was not currently deductible by the parent. The Court stated that the payment must be capitalized and added to the parent's basis in the assets acquired from the subsidiary.

In Portland Gasoline, the taxpayer purchased all the assets of a corporation in March of 1934 and agreed to pay a note the corporation had guaranteed in 1930. The court held that the taxpayer's payment of the note in 1943 to avoid a potential lawsuit was a capital expenditure because the threat of suit by the creditor derived from an obligation for which the selling corporation alone was liable.

In Rev. Rul. 76-520, target, a publishing corporation, incurred costs in fulfilling prepaid subscription contracts. Prior to the payment of those costs, the stock of target was acquired by another corporation (“Parent”) and target was liquidated. Parent paid the expenses. The issue of the ruling is whether the Parent may properly deduct the costs incurred in fulfilling the obligation of its former subsidiary to deliver certain periodicals. The ruling holds, “[c]osts incurred by the acquisition corporation in satisfaction of a liability of the acquired corporation assumed by the acquiring corporation as part of the acquisition costs must be capitalized and added to the basis of the acquired assets rather than currently deducted.”

Taxpayer cites VCA Corporation v. United States, 77-2 USTC ¶ 9554, aff'd 215 Ct. Cl. 939 (1977), in support of its argument that New Target is entitled to deduct the contingent liability amounts New Target had assumed even though Seller paid the liabilities. Although the case ostensibly appears to support Taxpayer's position, it is

nonetheless easily distinguishable from the present case and therefore, inapplicable to these facts.

In VCA Corporation, the VCA Corporation merged with Aerosol Research Company (Aerosol) in a tax-free reorganization qualifying under I.R.C. § 368(a)(1)(A). Under the terms of the merger agreement and applicable state law, VCA obtained all of the assets and assumed all of the liabilities of Aerosol. One such liability, a contingent liability, involved an employee of Aerosol who threatened to sue Aerosol for wrongful employment discharge. As part of the merger, the shareholders of Aerosol agreed to indemnify VCA for any liability arising from the employee's claim. Subsequent to the merger, the employee brought suit against VCA as the successor to Aerosol. VCA settled with the discharged employee and paid him \$234,397. VCA was reimbursed by the former Aerosol shareholders in the amount it had paid. VCA took a deduction for this amount in the year of payment, which the Service disallowed. VCA paid the deficiency, filed a refund claim, and ultimately filed a refund suit in the Court of Claims. The court found that VCA had assumed Aerosol's liabilities and that Code §§ 381(c)(4) and (c)(16) and the corresponding regulations (*i.e.*, Reg. §§ 1.381(c)(4) and (c)(16)) controlled whether VCA was entitled to the deduction. The court held that under § 381(c)(4), VCA was entitled to deduct the amounts it paid, even though it was subsequently reimbursed.

Our case is factually quite different from VCA Corporation and is not governed by § 381. The governing provisions of the VCA case (*i.e.*, Code §§ 381(c)(4) and (c)(16)) only apply to § 332 liquidations and to § 361 transactions and then only if the § 361 transfer is in connection with a reorganization described in subsections (A), (C), (D), (F) or (G) of § 368(a). Under the facts of our case, the parties to the purchase share agreement made a joint election under § 338(h)(10). Thus, §§ 332 and 361 do not apply and, therefore, § 381(a) does not apply either. There can be no carryover of Old Target's corporate tax attributes to New T, the successor corporation, without § 381(a).

Although Taxpayer is not entitled to deduct the amounts that Seller paid in discharge of the State franchise tax liability and the pre-acquisition interest (but it is entitled to deduct the post-acquisition interest even though that amount was paid by the Seller), Taxpayer does benefit. General tax principles hold that the Purchaser (here, New Target is deemed to be the purchaser) treats an assumed fixed liability as a cost of the acquired property and therefore includes such amount in its tax basis. Lifson v. Commissioner, 98 F.2d 508 (11th Cir. 1938), cert. denied, 305 U.S. 662 (1939); John Hancock Mutual Life Ins. Co. v. Commissioner, 10 B.T.A. 736 (1928).

Here, New Target makes an upward adjustment in the basis of its assets in the amount of the contingent liabilities and pre-acquisition interest at the time the contingent liabilities and pre-acquisition interest become fixed and determinable.

The mechanics of this upward adjustment is described in the regulations. As prescribed by § 338(b), the basis of the assets in the hands of New Target is called the “adjusted grossed-up basis” (“AGUB”) in the regulations. Temp. Reg. § 1.338-4T(j)(1). AGUB is defined in Reg. § 1.338(b)-1T(c). I.R.C. § 338(b)(1) and (2) provide that the target assets will be treated as having been purchased for an amount equaling: (1) The grossed-up basis of the purchasing corporation’s recently purchased stock; (2) the basis of the purchasing corporation’s nonrecently purchased stock; (3) old target corporation’s liabilities; and (d) other relevant items.

Specifically, with regard to the liabilities of Old T, Treas. Reg. § 1.338(b)-1T(f)(2)(i) provides that in order to be included in AGUB at the beginning of the day after the acquisition date, an obligation must be a bona fide liability of target as of that date, which is properly includible in basis under principles of tax law that would apply if new target had acquired old target’s assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the obligation.

Contingent liabilities do not initially qualify for inclusion in AGUB, but they are taken into account if and when they become fixed and determinable. Temp. Reg. § 1.338(b)-1T(f); see also Temp. Regs. § 1.338(b)-3T(c). Reg. § 1.338(b)-1T(f)(2)(ii) provides that obligations initially excluded from AGUB under paragraph (2) are taken into account in redetermining AGUB and the basis of target’s assets under principles of tax law applicable as if new target had acquired old target’s assets directly from an unrelated person and, as part of the transaction, had assumed or taken property subject to those obligations. See also section 1.338(b)-3T(a)(1) (similar language regarding general principles of tax law as applied to, for example, the change in a liability of old target from contingent to fixed and determinable).

Temp. Reg. § 1.338(b)-3T(b)(2)(ii) provides a definition of contingent liability (i.e., a liability that is “not fixed and determinable.” The regulations indicate that the change in a target liability to one which is fixed and determinable triggers operation of the -3T adjustment rules. Treas. Reg. § 1.338(b)-3T(a)(1), -3T(j), Example 1(iv). Temp. Reg. § 1.338(b)-3T(c)(1) provides that liabilities that become fixed and determinable more than one year after the acquisition are added to the purchase price at the time the liabilities become fixed and determinable and added to basis.

The Target was purchased on Date B and the State franchise tax liabilities became fixed and determinable on or around Date F, four years after Target’s acquisition. Thus, the State franchise tax liabilities and pre-acquisition interest that accrued on such liabilities became fixed and determinable more than one year after Target’s acquisition. Thus, Date F appears to be the day that these liabilities became fixed and determinable and, therefore, it appears that New Target became entitled as of Date F to make an upward adjustment to the basis of its assets by the amount of those liabilities.

B. Interest Accruing on the Unpaid State Franchise Tax Liabilities

As to the interest paid by the Seller, the general rule is that the taxpayer is entitled to an interest deduction, but only for that portion of the interest accruing after the acquisition date. Hyde v. Commissioner, 64 T.C. 300 (1975) (interest paid by the taxpayer as part of purchase price for mortgaged real estate deductible only to extent they accrued on or after the date on which he acquired an interest in the real estate). Thus, New Target is not entitled to deduct the pre-acquisition interest but it is entitled to deduct the post-acquisition interest paid by Seller. See also Zards v. Commissioner, T.C. Memo 1995-497.

C. Proper Tax Treatment of Seller's Payments Under the Indemnity Agreement

Generally, uncertainties typically surround the conclusion of a business bargain. To anticipate intervening changes in circumstances which may effect the value of the assets contracted for, parties to asset purchases employ contractual mechanisms that adjust the terms of the initial transaction to take into account changes in values and expectations. One such mechanism is an indemnity or tax sharing agreement. Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.66[1] and [5][b], at pp. 12-246 to 12-247, 12-275 (6th ed. 1998). Post-transaction payments made by the transferor under an asset sale agreement, such payments made to or on behalf of the acquiring corporation, are treated as capital expenditures by the payor and as tax-free adjustments to the purchase price by the payee. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952), 1952-2 C.B. 136.

In Arrowsmith, two shareholders liquidated their jointly-owned corporation and divided the proceeds equally. Both shareholders properly reported in the year of liquidation the receipt of the proceeds as capital gain. Four years after the liquidation, a judgment was rendered against the old corporation. The shareholders, as transferees, paid the judgment and both claimed ordinary income deductions for the amounts paid on their respective individual income tax returns. The Service disallowed these deductions, reasoning that they were part of the original liquidation transaction and therefore should be characterized as capital losses. In ruling in favor of the Service, the U.S. Supreme Court reasoned that the taxpayers' liability as transferees did not result from any business transaction apart from the liquidation. The Court concluded that, "in order to properly classify the nature of the 1944 loss for tax purposes," it was necessary to consider the earlier liquidation transaction.

Under the relation-back theory of Arrowsmith, a taxable transaction that is integrally related to an earlier transaction is to be characterized for tax purposes by reference to the earlier event. Here, Seller's agreement to indemnify Purchaser in essence was an inducement to Purchaser to buy T. Applying the Arrowsmith relation-back principle, Seller's inducement relates back to the original stock purchase agreement. Thus, when Seller paid Target's contingent liabilities (at the time they became fixed and determinable), Purchaser received a tax-free adjustment to the purchase price. See Estate of McGlothlin v. Commissioner, 370 F.2d 729 (5th Cir. 1967); Freedom Newspapers, Inc. v. Commissioner, T.C. Memo. 1977-429; Kaufmann v. Commissioner, 10 T.C.M. 790 (CCH) (1951); Rev. Rul. 83-73, 1983-1 CB 84.

The leading case dealing with the effect of an indemnity payment is Estate of McGlothlin, in which the Fifth Circuit Court of Appeals held that a cash indemnity payment made pursuant to an indemnity agreement that was an integral part of the merger agreement related back to the merger itself, and that the taxpayer could not claim a loss deduction because the payment related back to the time of the merger. In McGlothlin, the taxpayer, a majority shareholder of the corporation acquired in a merger, guaranteed that certain of the acquired corporation's properties could be sold within three years at a certain price. When the properties could not be sold for this amount, the taxpayer transferred \$ 250,000 to the acquiring corporation in satisfaction of the guaranty. The court ruled that the taxpayer could not deduct the payment as a loss under I.R.C. § 165. Because these payments were part of the "purchase price" of the acquiring corporation stock that he received in the merger, the taxpayer had to add this amount to his basis in the acquiring corporation's stock. Furthermore, the court indicated that I.R.C. § 354(a)(1) precluded recognition of a loss to the taxpayer because the indemnity agreement and the payment pursuant to the agreement were part of the tax-free reorganization itself. As authority for this position, the court cited Arrowsmith.

In Freedom Newspapers, Inc., a publishing company engaged a broker to sell some of its newspapers. A package of four newspapers was offered to Freedom Newspapers ("Freedom"), but Freedom did not want to buy one of the newspapers for various reasons, including the belief that it was overvalued. Freedom agreed to buy the four newspapers at the asking price as long as the broker agreed to resell the unwanted paper within one year for a stated price. If the sale did not occur, the broker agreed to pay Freedom \$ 100,000, which sum was placed in escrow during the one-year period. The broker was unable to sell the paper and the escrow agent paid over the \$ 100,000. The Service determined that the \$ 100,000 payment resulted in ordinary income to Freedom. The Tax Court concluded that the contract with the broker for the \$ 100,000 was part of the original sales agreement and represented a reduction in the net price paid for the paper. The Tax Court, citing Arrowsmith, held that a payment from a broker to a purchaser was an adjustment of the price of the assets purchased and was not ordinary income to the purchaser.

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The case of Kaufmann examined the tax treatment of amounts paid by the former shareholders of a transferor corporation pursuant to an indemnity agreement entered into as a condition of a nontaxable reorganization. The court held that the shareholders could not deduct the amounts paid in satisfaction of the indemnity agreement but must add such amounts to the basis of stock of the acquiring corporation that they received in the merger. The court reasoned that had the contingent liability covered by the indemnity agreement been known as of the date of the merger, it would presumably have been paid by the taxpayer along with the other liabilities. According to the court, "[T]hat action would have been treated as a contribution to capital, or as a part of the cost of the new shares of [the acquiring corporation], and as such have become an additional investment leading to an increase in [taxpayers'] basis for the new stock of [the acquiring corporation] received in exchange." (Citations omitted).

In Rev. Rul. 83-73, 1983-1 CB 84, X corporation merged with Z corporation in a transaction which qualified as a tax-free reorganization under I.R.C. § 368(a)(1)(A). Under the terms of the merger agreement, X corporation acquired all Z's assets and assumed all Z's liabilities, including contingent liabilities. As a condition to the merger, shareholders of Z corporation agreed to reimburse X corporation for any after-tax expenses that X might incur as the result of a claim that a former employee of Z corporation had against Z. X corporation ultimately paid the specific contingent claim and received reimbursement from the shareholders of Z. The revenue ruling, relying on Arrowsmith's relation-back principle, holds that the indemnity payments related back to the initial exchange and, therefore, the contingent obligation should be reflected in the consideration as a purchase price adjustment. The ruling stated, "the indemnity payments should be treated as if they had been contributions to the capital of the transferor corporation, made by its shareholders immediately before the merger."

Thus, applying the Arrowsmith relation-back approach to the facts of this case, the subsequent payments of the State franchise tax liabilities and pre-acquisition interest, payments made by the Seller pursuant to the tax agreement that was entered into as part of the original stock purchase agreement, should be treated as of the date of payment as a capital adjustment to the original consideration (i.e., the assets) received in the acquisition. The payments are applied as a downward adjustment to the basis of New Target's assets. Likewise, Seller's payment of the post acquisition interest is applied as a further downward adjustment to the basis of New Target's assets.

In conclusion, Taxpayer may only deduct post-acquisition interest paid by the Seller. Taxpayer may not deduct the State franchise tax liabilities and pre-acquisition interest paid by the Seller. With regard to basis adjustments, New Target makes an upward adjustment in the basis of its assets in the amount of the contingent liabilities and pre-acquisition interest as of the time those amounts

become fixed and determinable. Further, New Target makes an offsetting downward adjustment in the basis of its assets in the amount of the contingent liabilities and pre-acquisition interest as of Dates C and D, when Seller paid those amounts pursuant to the indemnity agreement that was entered into in connection with the stock purchase agreement. Regarding post-acquisition interest, New Target is not deemed to have assumed such interest. Thus, New Target is not entitled to an upward adjustment in the basis of its assets when the post-acquisition interest became fixed and determinable. Rather, New Target must reduce its basis in its assets in the amount of post-acquisition interest when those amounts were paid by the Seller pursuant to the indemnity agreement entered into in connection with a stock purchase (here, Dates C and D).

Please call if you have any further questions.

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