Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Internal Revenue Service
Industry Director, Heavy Manufacturing and Transportation
(Large & Mid-Size Business)

Internal Revenue Service
Director of Pre-Filing Technical Guidance
(Large & Mid-Size Business)

from: John P. Moriarty
Chief, Branch 1
(Income Tax & Accounting)

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subject: Withdrawal of letter ruling request

In accordance with section 7.07(2)(a) of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 29, we are advising you that a taxpayer within your operating division's jurisdiction has withdrawn a request for a letter ruling after this office advised the taxpayer of its conclusion adverse to the taxpayer's requested ruling. Following is a brief discussion of the issue, facts, applicable law, and the reasons for this office's conclusion. This memorandum may not be used or cited as precedent.

<u>LEGEND</u>

Taxpayer =
Seller =
Owner =
Parties =
x =
Date 1 =
Date 2 =

Date 3 =
Date 4 =
Date 5 =
Date 6 =

ISSUE

Does the fact that the liabilities assumed by Taxpayer were assumed in connection with the acquisition of assets in a transaction described in sections 363 and 365 of the Bankruptcy Code preclude capitalization under § 263 of the Internal Revenue Code?

CONCLUSION

The fact that the liabilities at issue were assumed in connection with the acquisition of assets in a transaction described in sections 363 and 365 of the Bankruptcy Code does not per se preclude capitalization under § 263.

FACTS

On Date 1, Seller filed bankruptcy petitions seeking relief under Chapter 11 of the United States Bankruptcy Code. On Date 2, Taxpayer and other interested parties filed with the bankruptcy court an asset purchase agreement (the Agreement), detailing the proposed sale of substantially all of Seller's assets to Taxpayer. The asset acquisition allowed Taxpayer to acquire tangible and intangible assets from Seller, including contracts to which Seller was a party. The Agreement also contained other provisions pertaining to the transfer of Seller's business to Taxpayer, including the terms under which Seller's employees would be offered employment by Taxpayer.

Taxpayer's ruling request pertained to liabilities that Taxpayer assumed under the terms of the Agreement. The Agreement states that Taxpayer assumed certain liabilities of Seller (the Assumed Liabilities) and paid cash consideration of $x to Seller in exchange for the assets. The Agreement further provides that the aggregate consideration provided by Taxpayer to Seller for the assets included both the assumption of the Assumed Liabilities and the cash consideration. Seller's financial advisor determined that the assumption of liabilities would benefit Seller and that the cash consideration combined with the assumption of the Assumed Liabilities was fair consideration for the assets from Seller's point of view.

The asset sale was approved by the bankruptcy court in an order dated Date 3, and the transaction closed on Date 4. The Agreement was amended in a series of amendments dated on or before Date 5 and a final amendment dated Date 6.

In the court's order authorizing the sale, the court found that the Agreement represented an arms-length transaction between the parties. In reaching this conclusion, the court stated---:

In the court's opinion granting Seller the authority to sell the assets, the court approved the terms of the Agreement, specifically noting the consideration recited in the Agreement consisting of the cash payment and the assumption of the Assumed Liabilities.

The court recognized that the amount of cash consideration reflected the liabilities that Taxpayer chose to assume in connection with assumed contracts. The court stated----:

The court concluded that the secured creditors could not have recovered $x in a piecemeal liquidation of Seller's assets. In support of this position, the court indicated that:

Finally, the court concluded that Taxpayer's assumption of unsecured liabilities as part of the transaction did not violate bankruptcy law. In reaching this conclusion, the court reasoned as follows:

In its ruling request, Taxpayer placed the Assumed Liabilities into three broad categories: (1) executory contract liabilities; (2) commercial interest liabilities; and (3) liabilities secured by liens against certain of the acquired assets that were not discharged in the bankruptcy. Taxpayer requested a ruling on liabilities described in categories (1) and (2). In response to notification that this office was tentatively adverse to Taxpayer's requested ruling, Taxpayer proposed further limiting the ruling request to nine broad categories of liabilities. These categories were: (1)

(2)

(3)

(4) workers' compensation liabilities under claims relating to pre-acquisition incidents; (5) active healthcare liabilities for unbilled medical services that were provided to employees before the acquisition; (6) post-retirement medical costs for certain former employees of Seller; (7) supplemental deferred pay liabilities related to certain employee life insurance plans; (8) restructuring reserves liabilities for future costs of certain restructuring activities which either had commenced or had been in planning stages before the acquisition; and (9) assumed contract liabilities. The final category, assumed contract liabilities, generally includes liabilities under all written contracts, leases, licenses, arrangements, notes, bonds, mortgages, indentures, franchise agreements, insurance agreements and arrangements, instruments, commitments, undertakings and other agreements and binding obligations to which Taxpayer, Seller or Owner is a party. These nine broad categories of Assumed Liabilities are composed of numerous separate liabilities. The Assumed Liabilities include both fixed and contingent liabilities.

<u>LAW AND ANALYSIS</u>

The underlying legal issue in this case is whether Taxpayer's assumption of liabilities must be capitalized to the basis of the acquired assets under § 263(a).[1] Section 263(a) disallows deductions for capital expenditures. A capital expenditure is an amount paid "for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263(a). The regulations explain that capital expenditures include any "cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year." Section 1.263(a)-2(a) of the Income Tax Regulations.

A buyer who purchases business assets and assumes a seller's liabilities, fixed or contingent, in connection with the acquisition must capitalize payments made on such liabilities. See, e.g., David R. 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). A buyer's payment of the liabilities is not the discharge of a burden the law placed on the buyer; it is actually as well as theoretically a part of the purchase price. Magruder v. Supplee, 316 U.S. 394, 398 (1942). As a factual matter, however, it is sometimes difficult to distinguish between contingent liabilities assumed from the seller and expenses the buyer incurs while operating the ongoing acquired business.

Case law identifies a number of factors to be considered in determining whether contingent liabilities must be capitalized. Illinois Tool Works v. Commissioner, 117 T.C. 39, aff'd, 355 F.3d 997 (7th Cir. 2004); David R. Webb Co., supra; Pacific Transport Co., supra; United States v. Smith, 418 F.2d 589 (5th Cir. 1969); Albany Car Wheel Co., supra; United States v. Minneapolis & St. Louis Ry., 260 F.2d 663 (8th Cir. 1958); M. Buten & Sons, Inc. v. Commissioner, T.C. Memo 1972-44. These factors include:

> 1) Whether the liability related to the seller's or the purchaser's operation of the business;
> 2) Whether the liability arose out of pre- or post-acquisition events;
> 3) Whether the purchaser was aware of the liability;
> 4) Whether the liability was contemplated when negotiating the purchase price;
> 5) Whether the purchaser expressly assumed the liability; and
> 6) Whether the purchaser could have avoided the liability.

In short, capitalization is required where the events most crucial to creation of the obligation occur before the acquisition, while deduction is allowed where the events most crucial to creation of the obligation occur after the acquisition. United States v.

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[1] The transaction implicates numerous other issues, including whether the payments are ordinary and necessary business expenses that are deductible under § 162; whether Taxpayer must capitalize the purchase of intangible assets, such as contract rights and/or goodwill; to what extent the payments must be capitalized to the cost of produced assets under § 263A; the timing of deductions or capitalization under § 461; and the timing of deferred compensation deductions under § 404. These issues were beyond the scope of Taxpayer's ruling request.

Minneapolis & St. Louis Ry., supra; Albany Car Wheel Co., supra; M. Buten & Sons, Inc., supra.

In support of its requested ruling, Taxpayer advanced several theories, which we group here into two main arguments. First, Taxpayer argued that the unique facts of its case showed that the assumption of liabilities was not, and legally could not have been, part of the purchase price that Taxpayer paid for the assets. In effect, Taxpayer reasoned that the fact that the liabilities assumed by it were assumed in connection with the acquisition of assets in a transaction described in sections 363 and 365 of the Bankruptcy Code precludes capitalization under § 263, both because the liabilities were economically worthless in the hands of Seller and because the liabilities could have been avoided by Taxpayer and ultimately discharged by the bankruptcy court. Second, Taxpayer argued that because of these unique facts, an analysis of the traditional factors outlined above demonstrates that the Assumed Liabilities were not part of the purchase price of the assets. Thus, under these arguments, Taxpayer would not be required to capitalize any of the assumed liabilities to the purchase price of the assets ("bright line arguments"). For the reasons discussed below, we did not find Taxpayer's arguments to be persuasive.

Bankruptcy-focused bright line arguments

In support of its first argument, Taxpayer asserted that the bankruptcy court determined that Taxpayer purchased the assets for $x, that the assumed liabilities were not part of the purchase price, and that the secured creditors received the full purchase price for the assets. Taxpayer's arguments largely relied on the court's statement that Taxpayer's assets were valued at less than $x. However, in making this statement the court was not calculating Taxpayer's purchase price for the assets. Instead, the court was concluding that Seller could not have received more than $x in a piecemeal liquidation of the secured assets. The Agreement approved by the court provided that Taxpayer purchased the assets in exchange for consideration in the form of a cash payment and the assumption of the Assumed Liabilities. In approving the Agreement, the court found that it was an arms-length transaction, specifically noting that the amount that Taxpayer was willing to pay was affected by which contracts Taxpayer chose to assume, the assumption of which also required Taxpayer to assume the liabilities to make cure payments. Similarly, the court's conclusion that the secured creditors received fair value for the secured assets was merely a conclusion that the secured creditors would not have received more in a liquidation. It was not a conclusion that an arms-length purchaser would have been unwilling to assume a large number of liabilities, in addition to paying cash of $x, in order to acquire substantially all of Seller's assets and assume a large number of Seller's contracts in order to use those assets and contractual relationships to operate its trade or business. In short, the issue before the bankruptcy court was not Taxpayer's cost of acquiring the assets; the issue was whether the secured creditors could have received more than $x in a piecemeal liquidation of the secured assets and whether any cash proceeds from the asset sale flowed to any party other than the secured creditors. The bankruptcy court was not concerned with the amount of consideration Taxpayer paid for the assets for purposes of Federal tax law.

Taxpayer next argued that Taxpayer could not have paid more for the assets than what Seller (or the secured creditors) received; namely, the amount of cash consideration. At the core of this argument was a purported distinction between the purchase price for the assets and the total costs incurred in acquiring the assets. In other words, Taxpayer argued that any amounts in excess of what Seller received could be characterized as costs related to the acquisition of the assets, but could not be characterized as the purchase price for the assets. Taxpayer did not provide any precedent for drawing this distinction between purchase price and other costs in capitalizing expenditures incurred in acquiring an asset. Federal tax law consistently looks to a seller's amount realized as the starting point for calculating gain or loss, and it looks to a purchaser's cost as the starting point for calculating basis. See §§ 1001(a) and 1012(a). Absolute symmetry between amount realized and cost is not required. For example, § 1060 addresses the allocation of the amount of consideration received by the seller of assets for purposes of determining the purchaser's basis in the assets and the seller's gain or loss on the sale. The regulations define consideration differently for the seller and the purchaser—amount realized for the seller, cost for the purchaser—making it clear that the amount of consideration may be different for each party. Section 1.1060-1(c)(1). Therefore, distinguishing the cash consideration that Taxpayer paid from the liabilities that Taxpayer assumed, by characterizing the cash as purchase price and the liabilities as other costs of the acquisition, does not alter the result under § 263. Because the amount that Taxpayer is required to capitalize under § 263 is not dependent on the amount that Seller received from Taxpayer, we did not agree with Taxpayer that capitalization is precluded if, as Taxpayer argued, Seller received no benefit from Taxpayer's assumption of the liabilities because the liabilities were economically worthless and ultimately would have been discharged in the bankruptcy proceeding.

As final support for its first argument, Taxpayer argued that characterizing the assumption of liabilities as part of the purchase price of the assets violates bankruptcy law because this characterization implies that the unsecured creditors received a portion of the purchase price, thereby bypassing the secured creditors. In support of this argument, Taxpayer cited Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), in which the Service sought to apply § 482 to recharacterize reinsurance premiums paid to a related entity as insurance commissions paid to banks, at a time when banks were prohibited under federal law from receiving insurance commissions for acting as insurance agents. The Court held that this recharacterization was improper because the banks never received shares of the premiums and never could have received them because they were legally prohibited from doing so. The Court noted that there was no finding in the case, and nothing in the record to support a finding, that the banks had acted illegally. The Court gave "great weight" to the fact that the banks had been regularly examined by federal banking authorities, who found no violations of the law, as well as to the assumption by the government and the lower courts that the activity was lawful. Id. at 402 n.16.

Taxpayer argued that First Security Bank of Utah supports the proposition that "courts have generally not applied a tax result that was in conflict with prevailing law." This argument was not persuasive because, in reaching its decision, the Court in First Security Bank of Utah noted that the form of the transaction and the legal prohibition against receipt of commissions were consistent in reflecting the fact that the banks did not and could not receive commissions. In the present case, the form of the transaction, as reflected in the Agreement, was an assumption of liabilities in exchange for assets, which is consistent with bankruptcy law that allows a purchaser of assets in a § 363 sale to assume unsecured liabilities in connection with the purchase. The Agreement specifically stipulates that the Assumed Liabilities are part of the consideration and, in approving the sale, the bankruptcy court specifically determined that the assumption of unsecured liabilities in a § 363 sale does not violate the rights of secured creditors. In particular, the court noted that a purchaser of assets may, for business reasons, decide to assume unsecured liabilities of a seller, and that the assumption of the liabilities does not violate bankruptcy law. Indeed, in the present case, the secured creditors consented to the transaction. In short, Taxpayer's reliance on First Security Bank of Utah was misplaced.

Because we did not find persuasive authority for Taxpayer's bankruptcy-focused bright line arguments that would allow Taxpayer to avoid capitalizing the assumed liabilities, we turned to the traditional facts and circumstances analysis used in determining whether contingent liabilities should be considered part of the purchase price of an asset.

Facts and circumstances bright line argument

In support of its second argument, Taxpayer asserted that an analysis of the traditional factors for determining when contingent liabilities are part of purchase price demonstrates that the Assumed Liabilities were not part of the purchase price of the assets in this case. In addressing this argument more specifically, Taxpayer proposed further limiting the ruling request to the nine broad categories of liabilities discussed above. For the reasons described below, we were unable to conclude that the Assumed Liabilities are not subject to capitalization under § 263 when considered collectively in the broad categories described by Taxpayer.

First, Taxpayer's analysis of broad categories of liabilities did not account for fixed liabilities that Taxpayer assumed as part of the transaction at issue. For many of the Assumed Liabilities, the factors used in the traditional facts and circumstances analysis are not relevant because they apply in determining when contingent liabilities should be considered part of the purchase price of an asset. Many of the liabilities in this case appeared to be Seller's operating expenses incurred before the transaction that are not contested or otherwise contingent, such as accounts payable to suppliers. That is, many of the liabilities appear to be fixed. In these cases, there was no need to examine the factors described above as, under the facts of this case, the liabilities existed and were assumed as part of the acquisition. Furthermore, Taxpayer's application of the various factors developed under case law for considering contingent liabilities was not persuasive. The various case law factors are addressed briefly below.

Factors 1 and 2

The traditional facts and circumstances analysis first considers whether the liabilities relate to the seller's or the purchaser's operation of the business and whether the liabilities arose out of pre- or post-acquisition events. Taxpayer generally argued that the liabilities related to the purchaser's operation of the business because Taxpayer elected to honor the liabilities in order to maintain strong customer relationships and because Taxpayer could have purchased the assets free and clear of the liabilities under § 363(f) of the Bankruptcy Code. We were not persuaded by this argument because the information provided by Taxpayer showed that the Assumed Liabilities related to Seller's operation of the business. The liabilities existed at the time of the asset acquisition and were incurred by Seller. The fact that Taxpayer was not legally obligated to assume any of the liabilities in connection with the purchase of Seller's assets did not change the fact that the liabilities arose out of the pre-acquisition business dealings of Seller. In other words, Taxpayer voluntarily chose to assume the liabilities as part of the acquisition, but the voluntariness does not transform the liabilities from pre-acquisition liabilities to post-acquisition liabilities.

Factors 3 and 4

Taxpayer agreed that it was aware of the liabilities at the time of acquisition, so we next considered whether the liabilities were contemplated when negotiating the purchase price. Taxpayer argued that the assumed liabilities were not a factor in negotiating or setting the purchase price of the acquired assets, and that the cash consideration was the full purchase price, because the bankruptcy court concluded that the value of the assets was less than $x. We did not agree with Taxpayer that the bankruptcy court's conclusion regarding the valuation of the assets implies that the valuation of the liabilities was not a factor in the negotiations in this arms-length transaction. In fact, court records show that Seller's financial advisor took the valuation of the liabilities into account in concluding that the transaction as a whole was fair from Seller's viewpoint--.

Taxpayer also argued that two specific types of liabilities could not have been part of the purchase price because they were assumed after the closing date; namely, the liabilities assumed under contracts that were designated for assumption after the closing date, and the liabilities assumed pursuant to the amendment to the Agreement dated Date 6. Based on the limited information that Taxpayer provided, we were unable to conclude that these liabilities should not be capitalized merely because details regarding their incorporation into the Agreement were not completed until days or months after the closing date.

Factors 5 and 6

Because Taxpayer agreed that it expressly assumed the liabilities, the final factor to be considered was whether the purchaser could have avoided the liability. Taxpayer argued that it could have avoided the liabilities because bankruptcy law would have permitted the sale of assets without the assumption of the liabilities. However, the information provided by Taxpayer showed that Taxpayer agreed to assume the liabilities in exchange for the assets in an arms-length transaction in which Taxpayer chose the liabilities it wished to assume in light of the value of the assets it was acquiring. Once the transaction was completed, Taxpayer could no longer avoid the liabilities. For example, Taxpayer assumed liabilities under various supply contracts with respect to which Taxpayer is required to pay cure amounts but which Taxpayer otherwise may cancel at any time. While Taxpayer has the ability to avoid liabilities relating to future supply orders (by opting not to order the supplies), once the asset acquisition was completed Taxpayer could no longer avoid the liability to make the cure payments under the contracts. The fact that Taxpayer was not legally required to assume the liabilities for bankruptcy purposes is not relevant. Taxpayer voluntarily chose to assume the Assumed Liabilities in exchange for the assets.

Conclusion

In conclusion, we were unable to provide Taxpayer's requested ruling that the fact that the liabilities at issue were assumed in connection with the acquisition of assets in a transaction described in sections 363 and 365 of the Bankruptcy Code precludes capitalization under § 263. Further, we were unable to conclude that, under the traditional facts and circumstances analysis, the Assumed Liabilities are not subject to capitalization under § 263 when considered collectively in the broad categories described by Taxpayer. We note that considering the Assumed Liabilities in the broad categories described by Taxpayer necessarily precluded a detailed analysis of specific liabilities assumed by Taxpayer in the transaction. Such an analysis might have resulted in the conclusion that particular liabilities need not be capitalized under § 263 as part of the acquisition of assets. For example, Taxpayer stated that the restructuring reserves liabilities include liabilities for restructuring activities that were merely in the planning stages before the acquisition. While we lacked sufficient factual information to conclude categorically that Taxpayer is not required to capitalize any of these liabilities, a detailed analysis of the facts and circumstances may have shown that all or a portion of these liabilities are not required to be capitalized under § 263.

Please call at if you have any further questions.

cc: