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SPECIAL REPORT
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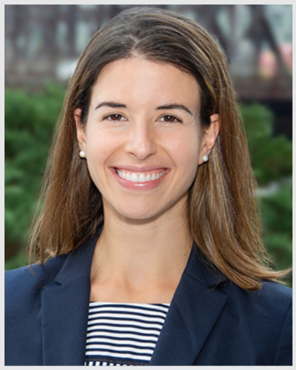
by Abraham Leitner and Leah B. Segal

Abraham Leitner



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In this report, Leitner and Segal explore how the economic performance requirement of section 461(h) affects the rule of *Oxford Paper* as it applies in different contexts and ultimately whether the rule is still valid in underwater leasehold assumptions.

This report is based on a paper the authors presented to the Tax Club on November 28, 2018.

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I. Introduction

Although it has been 70 years since *Oxford Paper*[1] was decided by the Second Circuit, the case continues to be a focus of questions about the tax law's treatment of obligations that are assumed as consideration in transactions, and the decision continues to serve as a guidepost for inventive practitioners seeking to structure transactions involving those assumptions. *Oxford Paper* is cited for the proposition that a taxpayer who receives consideration for assuming a lease that obligates the lessee to pay above-market rent (in other words, a transaction in which the buyer receives — rather than pays — consideration) does not have taxable income. Since *Oxford Paper* was decided, several other authorities have addressed the scope of its rule, limiting it in several respects to the point that many practitioners today are unfamiliar with the case or its ramifications.

Congress enacted the economic performance requirement under section 461(h) in 1984, more than 30 years after the *Oxford Paper* decision. That requirement has called into question when liabilities assumed in an acquisition are to be treated as incurred by the buyer. Under section 461(h), liabilities are not treated as having been incurred by a taxpayer until economic

[1] *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d Cir. 1952), *rev'g* 15 T.C. 361 (1950).

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performance occurs, and the timing of when economic performance occurs varies depending on the nature of the liability. This report examines the impact of the economic performance requirement of section 461(h) on the holding of *Oxford Paper* as it applies in different contexts. Ultimately, it considers whether the rule of *Oxford Paper* is still valid in an underwater leasehold assumption, such as the one addressed by the Second Circuit in *Oxford Paper*, or whether section 461(h) and its interpreting authorities would dictate a different outcome in that situation today.

II. Assumed Liabilities as Consideration

A. *Crane* and Its Progeny

The tax treatment of assumed liabilities in an acquisition stems from the 1947 *Crane*[2] decision and its progeny. *Crane* has come to stand for the now-axiomatic proposition that in an acquisition, a liability incurred as consideration for the property acquired is taken into account as part of the cost of that property and should be included in basis.[3] In practice, however, applying the rule of *Crane* to an acquisition requires several preliminary determinations. First, it must be determined whether the acquirer has in fact assumed an obligation or taken ownership of the property "subject to" the obligation, as opposed to the transferor's remaining liable for it. Second, the amount of the obligation (which may be fixed or uncertain) must be determined. Finally, even in a situation in which the amount of the obligation is fixed and can be determined with certainty, it must be ascertained whether the assumed obligation is a true liability for tax accounting purposes as of the time of the acquisition or is instead a mere expectancy that will ripen into a liability in the future. The economic performance doctrine focuses largely on that last question.

B. *Oxford Paper*

Oxford Paper[4] involved a somewhat atypical fact pattern: The seller in the transaction at hand was so eager to rid itself of the obligations with which it was burdened that it paid cash to the purchaser to complete the transaction instead of requiring the purchaser to pay the seller for the sale. The taxpayer, Oxford Paper Co., acquired a plant under an agreement with its wholly owned subsidiary, Rumford Falls Power Co., and a third-party lessee, Continental Paper and Bag Corp. Alongside the plant, Oxford assumed Continental's approximately $70,000 annual lease obligations for water rights. According to the acquisition agreement, Continental would convey to Oxford the plant and its leased rights, and Continental would pay Oxford $100,000 in cash, as well as an additional $6,000 in the form of stock of another corporation.

The issue to be decided was how to determine Oxford's depreciable basis in the plant that it acquired. Oxford took the position that because it had not paid anything in the transaction, the cash it received from the seller and the fair market value of the plant were both includable in its income in the year of the acquisition. Oxford argued that its basis in the plant, for purposes of depreciation, was the FMV of the plant, which it had included in gross income.[5] The government, on the other hand, contended that Oxford's basis in the plant was its cost to Oxford — that is, zero.

The Tax Court held in favor of Oxford.[6] On appeal, however, the Second Circuit reversed and held that the property Oxford received was *not* includable in income in the year of acquisition. Rather, the property had been acquired in exchange for the obligations Oxford assumed under the lease, less the $100,000 of cash it received. The court did not explicitly address the treatment of the cash payment to Oxford but clearly viewed it as being offset by a portion of the obligations assumed under the lease. As such, the cash should not have resulted in taxable income to Oxford, which is how subsequent authorities have interpreted the holding of *Oxford Paper*.

Oxford had contended that the property it received was income, analogizing to *Hort*,[7] in

[2] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[3] *See id.*; *Stackhouse v. United States*, 441 F.2d 465, 467 (5th Cir. 1971); and *Bertoli v. Commissioner*, 103 T.C. 501 (1994).

[4] *Oxford Paper*, 194 F.2d 190.

[5] Oxford took that position because it had enough in the way of deductions to fully offset the inclusion in income in the year of acquisition.

[6] *Oxford Paper*, 15 T.C. 361.

[7] *Hort v. Commissioner*, 313 U.S. 28 (1941).

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which payments made in cancelation of a lease to the taxpayer-lessor were held to be income. The Second Circuit found *Hort* inapplicable because in *Oxford Paper*, the taxpayer was not the lessor and the lease was not canceled. The analogy did not extend to *Oxford Paper* because, unlike in *Hort*, the amount paid in cancelation was not a substitute for amounts that plainly would have been income in the taxpayer's hands were it not for the cancelation.

The *Oxford Paper* purchase price borne by the seller suggests that the parties reached an agreement that the approximate value of the assumed liabilities less the property subject to the acquisition — absent the cash and unrelated stock paid — was $106,000. Ostensibly, the property had some positive value, which implies that the liabilities had a negative value exceeding -$106,000. One would imagine that the value of the property would serve as an accurate proxy for the negative value that the parties ascribed to the lease, in which case the basis of the property would in fact equal its value. However, *Oxford Paper* was decided some 70 years ago, when modern economic theory was less prevalent in tax jurisprudence, and the Second Circuit gave credence to evidence suggesting that the lease actually had positive value. The court therefore required the taxpayer to demonstrate what part of the assumed obligations were allocable to the plant to establish its cost basis for depreciation, as if that demonstration could be made independently of the value of the property.

Oxford Paper presumes without any discussion that the payment obligations assumed by Oxford under the lease constituted liabilities that gave rise to basis to the extent that Oxford received consideration for their assumption. Significantly, the court appears to have ignored whether those payments could have properly been accrued by Oxford as liabilities for tax purposes when it assumed the lease. Notably, although the case predates the enactment of the section 461(h) economic performance requirement, those lease obligations would almost certainly not have been deductible before the period for which the future lease payments were required to be made to the lessor. In fact, the rental amounts for future years would not have been deductible currently even if they had been prepaid directly to the lessor.[8]

C. Rev. Rul. 55-675

Three years after the Second Circuit's decision in *Oxford Paper*, Rev. Rul. 55-675, 1955-2 C.B. 567, was published. It essentially adopted the approach of *Oxford Paper*, with the caveat that any amounts that were too contingent or indefinite to which to readily ascribe a present value could not be included in basis. The fact pattern for Rev. Rul. 55-675 involved two unrelated taxpayers,[9] A and B, each of which was party to a lease with the same lessor for adjoining lands. The leases had similar termination provisions, including that in the event of termination, the lessee at its own expense would be required to place the property in "standby condition." B's business was unprofitable, so it entered an agreement with A under which A assumed B's obligations under the lease and B transferred to A significant amounts of supplies and equipment (belonging to B) located on the leased land, plus a payment of cash.

Rev. Rul. 55-675 presented two questions. First, did A realize any taxable income as a result of the property and cash B transferred to it in consideration of A's assumption of B's liabilities? Second, how would A determine basis for the depreciation of the property it acquired under the agreement?

The revenue ruling concluded that A would *not* recognize any taxable income from the assets and cash it received in consideration for its assumption of B's liabilities. In so finding, the ruling clarified that the fact pattern presented was

[8] *See, e.g.*, *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285 (1944) ("For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year."); *Baton Coal Co. v. Commissioner*, 19 B.T.A. 169, 171 (1930), *aff'd*, 51 F.2d 469 (3d Cir. 1931) ("Where expenditures are in part a consideration for the use of rented premises for years other than the taxable years, the whole thereof can not properly be considered ordinary and necessary expenses of carrying on the business during the taxable years, and only the part thereof properly attributable to the process of earning income during the taxable years may be deducted from gross income for those years.").

[9] The lessor in *Oxford Paper* was related to the assignee-purchaser, but not to the original lessee, and the assignor and assignee were unrelated.

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distinguishable from one in which a lessee pays a lessor for cancelation of a lease. In that case, the FMV of any property paid to the lessor for cancelation would be taxable income to the lessor because that payment would represent a substitute for rental payments, which are expressly characterized and reportable as gross income for federal income tax purposes. Thus, once the FMV of property is included in income, the property has a basis for depreciation and other purposes equal to the value at which it was included in income.

In the fact pattern of Rev. Rul. 55-675, by contrast, absent realization of income by the acquirer upon the acquisition of the property, the assets have a basis equal to cost for A for purposes of gain or loss, depreciation, and invested capital. That cost generally includes the obligations that A assumed. Where the revenue ruling then veers off from and augments the rule set forth by *Oxford Paper* is in its conclusion regarding contingent and indefinite liabilities (whereas the *Oxford Paper* decision assumed that liabilities were definite in amount). Rev. Rul. 55-675 determined that cost basis cannot include any amount for "obligations which are so contingent and indefinite in nature that they are not susceptible of present valuation." As a result, for those contingent and indefinite obligations, no amount can be included in cost "until such time as they become fixed and absolute and capable of determination with reasonable accuracy." Finally, the revenue ruling concluded that cost, once determined, must be ratably allocated among properties received based on their relative FMVs.

Two further points are worth mentioning about Rev. Rul. 55-675. First, although the ruling precludes taking contingent liabilities into account in the determination of the taxpayer's basis, it does not reach beyond *Oxford Paper* to require that the liabilities actually be of a sort that the assignee could otherwise accrue for tax purposes (and presumably, the costs of returning the property to standby condition were not deductible before the lease termination). Second, the ruling's conclusion that contingent liabilities are not taken into account is limited to the determination of the taxpayer's basis in the property it received; the ruling itself does not conclude that the taxpayer is taxable on the receipt of the cash and property. However, later private letter rulings extend the reasoning of Rev. Rul. 55-675 to its logical corollary and conclude that contingent liabilities cannot be used to offset cash received by the taxpayer.[10] Thus, when the amount of cash received exceeds the amount of fixed liabilities, the taxpayer must include the excess in its taxable income.

III. The Economic Performance Requirement

Before 1984, under the accrual method of accounting, an expense was deductible for the tax year in which (1) all the events had occurred that determined the fact of the liability and (2) the amount thereof could be determined with reasonable accuracy (the all-events test).[11] If the all-events test was satisfied, an accrual-basis taxpayer generally could deduct the full face amount of the liability (ignoring any discounting of the amount to reflect the time value of money). The Joint Committee on Taxation's report on the Deficit Reduction Act of 1984 explained that Congress wasn't satisfied with the all-events test:

> Congress believed that the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money and the time the deduction is economically incurred. Recent court decisions in some cases permitted accrual method taxpayers to deduct currently expenses that were not yet economically incurred (i.e., that were attributable to activities to be performed or amounts to be paid in the future). Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the

[10] *See, e.g.*, LTR 200123046 and LTR 200034007, each concluding that the buyer will realize ordinary income on Class I assets it received in excess of consideration paid to the seller when the buyer cannot take additional consideration into account until it satisfies economic performance for the assumed liability.

[11] *See* Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84 (Dec. 31, 1984); and H.R. Rep. No. 98-4170, at 258 (1984). The all-events test was articulated by the Supreme Court in *United States v. Anderson*, 269 U.S. 422 (1926): "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."

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> expense to the extent that the time value of money is not taken into account; the deduction is overstated by the amount by which the face value exceeds the present value of the expense. The longer the period of time involved, the greater is the overstatement.[12]

It was against this backdrop that Congress enacted the economic performance requirement.

A. Section 461(h)

In 1984 Congress addressed these perceived flaws in the all-events test by adding section 461(h) to the code. Section 461(h) provides generally that in determining "whether an amount has been incurred for an item, the all events test shall not be treated as met any earlier than when economic performance with respect to the item occurs." When economic performance occurs for purposes of section 461(h) depends on the nature of the source of the liability. Subject to enumerated exceptions, the following rules apply:

- If the liability arises out of the provision of services to the taxpayer by another person, economic performance occurs as those services are provided.
- If the liability arises out of the provision of property to the taxpayer by another person, economic performance occurs when that property is provided.
- If the liability arises out of the use of property by the taxpayer, economic performance occurs as the taxpayer uses that property.
- Finally, if the liability requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides that property or those services.

Section 461(h)(4) adds that the all-events test is met for purposes of section 461(h) if all events have occurred that determine the fact of the liability and the amount of that liability can be determined with reasonable accuracy.

Notably, section 461(h) frames the economic performance requirement as a condition for satisfying the all-events test, but the all-events test itself predated section 461(h) and is a long-standing fixture of the accrual-method tax accounting rules. Historically, the all-events test was understood to be relevant only to the timing of deductible expenses for accrual-method taxpayers.[13] Section 461(h) refers to the timing of when an item is treated as being incurred but is silent on whether the statute should be applied only to deductions or should apply to capitalized expenses as well. The legislative history, however, supports the interpretation that section 461(h) was intended to apply to capitalized expenses as well as to deductible ones. For example, the House Ways and Means Committee report to the 1984 act states:

> In general, the House bill provides that in determining whether an accrual method taxpayer has incurred an amount during the taxable year, all the events which establish the taxpayer's liability for such amount will not be deemed to have occurred any earlier than the time when economic performance occurs. *If economic performance has occurred, the amount will be treated as incurred for all purposes of the Code. Amounts incurred are deductible currently only if they are not properly chargeable to a capital account* and are not subject to any other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs (which is consistent with the view the Service has taken).[14] [Emphasis added.]

The italicized language indicates that an amount can be incurred within the meaning of section 461(h) and still not be deductible because it is chargeable to a capital account. The strong implication is that an amount that has not been incurred within the meaning of section 461(h) would also be treated as not having been incurred for purposes of being charged to a capital account.

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[12] JCT, *supra* note 11. *See also* H.R. Rep. No. 98-4170, at 260.

[13] Reg. section 1.461-1(a)(2) (1967) (stating that "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy").

[14] H.R. Rep. No. 98-861, at 871 (1984).

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Consistent with the foregoing, reg. section 1.461-1(a) was amended in 1992 to read:

> (2) Taxpayer using an accrual method.
>
> (i) In general. Under an accrual method of accounting, a liability (as defined in section 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. . . . *Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. . . . As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization* (within the meaning of section 1.263A-1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits. [Emphasis added.]

The preamble to the 1992 regulations explains:

> The Service and the Treasury Department believe section 461(h) and its legislative history indicate that Congress intended the rules of section 461(h) to apply to both exclusions and deductions. First, section 461(h) and the all events test codified therein are not limited to deductions. Unlike the old all events test contained in section 1.461-1(a)(2) of the regulations, which applied to determine when an "expense" was "deductible," the all events test in section 461(h)(4) applies to determine when "any item" is "incurred." Second, the legislative history contemplates the application of the economic performance rules to capital items or other items that are not deductible in the year incurred. Third, adoption of the commentators' position would unreasonably narrow the scope of the economic performance rules relating to the provision of services and property in sections 461(h)(2)(A) and (B) to items that are merely incidental to the provision of services and property, such as deductible supplies and distribution costs. . . . Therefore, the final regulations continue to apply economic performance to both exclusions and deductions.[15]

In other words, the drafters of the regulations interpreted section 461(h) as not only modifying the determination of when the all-events test is satisfied but also codifying the all-events test itself as a new expanded rule governing when liabilities may be taken into account for all tax purposes under the code. Although the regulations under section 461 are silent on the treatment of assumed liabilities for a buyer in the acquisition of a trade or business, the language of reg. section 1.461-1(a) and the comments in the preamble leave no doubt that the regulations were intended to govern the timing of when amounts are treated as incurred for purposes of capitalization as well as deductibility.[16] As described below in the discussion of the nuclear decommissioning cases and rulings, this is the reading that the IRS and courts have adopted.[17]

B. Nuclear Decommissioning Authorities

The IRS has issued many private letter rulings addressing the tax treatment of sales of nuclear plants in which the purchaser assumes the legal obligations imposed on the operators of those plants to safely decommission them at the end of

[15] Preamble to T.D. 8408.

[16] Reg. section 1.461-4(d)(5) does expressly address the treatment of liabilities assumed in connection with the sale of a trade or business as the timing relates to the seller.

[17] *See, e.g.*, LTR 200243022.

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their useful life.[18] These rulings have considered — among many other questions — whether the buyer can take into basis at the time of the acquisition the liabilities it must assume for eventually decommissioning the plant in accordance with federal law. Nuclear power plants and their disposition are subject to a complex regulatory scheme under section 468A, particularly regarding their ultimate decommissioning when they are retired from use. Section 468A allows as a deduction for any tax year the amount of payments made by the taxpayer to a nuclear decommissioning reserve fund during that tax year, limited to an amount approved by the Treasury secretary for that year under a ruling request by the taxpayer. The deduction under section 468A is not subject to the all-events test or the economic performance requirement.

It's little wonder that there is a special provision allowing the deduction of amounts contributed to a nuclear decommissioning reserve fund; the decommissioning liabilities may be extreme in scale. Although the letter rulings don't disclose the extent of the liabilities, the taxpayer in *AmerGen*,[19] discussed below, had included in its basis for the acquisition of three plants an aggregate of $2.15 billion in decommissioning liabilities. However, nuclear plant operators commonly set aside reserve funds substantially exceeding the amounts permitted by section 468A, and the treatment of those excess amounts is governed by ordinary accrual-method accounting rules, including the economic performance requirement.

In the nuclear plant rulings, the IRS has said that the buyer may not take liabilities related to the eventual decommissioning of the plant into account at the time of the acquisition.[20] For instance, in LTR 200243022, the seller had maintained two separate funds for the eventual decommissioning of its nuclear power plant: a fund qualifying under section 468A (the qualified fund), and a fund that did not meet the requirements of section 468A that was treated as a grantor trust (the nonqualified fund). Under an asset purchase agreement, the seller planned to transfer to the buyer its plant as well as all the assets the seller had placed into the qualified and nonqualified funds (with numerous other complexities factoring into the transaction).

One of the requested rulings in LTR 200243022 was that the buyer would not recognize any income for federal income tax purposes as a result of any transfer of the assets in the seller's nonqualified fund to the buyer's nonqualified fund or the seller's transfer to the buyer of "any rights in funds held by State for the disposal of low-level radioactive waste during decommissioning, except to the extent that the amount of cash and other Class 1 assets (as such term is defined in section 1.338-6T) received by Buyer exceeds the amount of consideration paid by Buyer (as determined under Section 1060)." The IRS concluded that to address the request, it had to first make several preliminary determinations, including the buyer's cost basis. That posed the question whether the buyer was entitled to treat the future decommissioning liability as a component of its cost basis in the assets purchased from the seller, which turned on whether the liability would be incurred for tax purposes as of the closing. The IRS found that it would not be so incurred because of the economic performance requirement created by section 461(h) and its regulations.

The IRS determined that the buyer could not include the future decommissioning liabilities in cost basis because economic performance would not have occurred under reg. section 1.461-4(d)(4), governing liabilities arising out of services provided *by* the taxpayer: "Economic performance does not occur with respect to a service liability such as the decommissioning liability until and to the extent that costs are incurred in satisfaction of that liability." Thus, the ruling found that because the buyer would not have performed any services concerning the decommissioning liability at the time of the plant's purchase, "economic performance will not have occurred, and the liability will not have been incurred at that time for any purpose under the

[18] For several examples of these rulings, see LTR 200546037, LTR 200448002, LTR 200443003, LTR 200243022, and LTR 200123046. Although we haven't reviewed all the rulings on the topic, it appears that there are close to 100 of them.

[19] *AmerGen Energy Co. LLC v. United States*, 782 F.3d 1354 (Fed. Cir. 2015), *aff'g* 113 Fed. Cl. 52 (2013).

[20] Based on the rulings we have reviewed, it seems reasonably safe to assume that the IRS's position has been consistent in disallowing deductions at the time of the transaction.

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Internal Revenue Code, including the cost basis provisions of section 1012."

On the other hand, LTR 200243022 found that economic performance *was* satisfied for the seller at the time of the acquisition, allowing current ordinary deductions for any amounts treated as realized by the seller, or otherwise recognized as income to the seller, as a result of the buyer's assumption of the seller's decommissioning liabilities related to the plant. In so determining, the letter ruling looked to two parts of the section 461 regulations.

First, it noted that reg. section 1.461-4(d)(5) provides an exception to the general economic performance rule for services when the taxpayer sells a trade or business. When the purchaser expressly assumes a liability arising out of the taxpayer's trade or business that the taxpayer, but for the economic performance requirement, would have been entitled to incur as of the date of the sale, economic performance for the liability occurs "as the amount of the liability is properly included in the amount realized on the sale by the taxpayer." Second, the IRS noted that the second prong of the all-events test — requiring that the amount of the liability be reasonably determinable[21] — was also satisfied: "In the instant case, the amount of Seller's decommissioning liability has been determined by experts in the nuclear decommissioning industry." In so determining, the IRS implicitly acknowledged that the timing for the seller and the buyer under the reg. section 1.461-4 rules clearly need not match.

The treatment of nonqualified nuclear decommissioning reserve funds was finally addressed by a court in *AmerGen*, first in 2013 by the Court of Federal Claims,[22] and then in 2015 on appeal to the Federal Circuit.[23] AmerGen Energy Co. had acquired three nuclear power plants — Three Mile Island Unit-1, the Clinton Power Station, and the Oyster Creek Nuclear Generating System — and had assumed responsibility for their operations. AmerGen also received from the seller \$393 million in qualified funds and \$581 million in nonqualified funds. The purchase price of the three plants and their related assets was \$93 million, before the inclusion of assumed liabilities. AmerGen asserted that it also assumed the future decommissioning liabilities associated with each plant and that the liabilities should therefore be included in its cost basis. Thus, the total basis of the acquired assets set forth by AmerGen would be \$2.24 billion, rather than the \$93 million amount it paid to the seller. That basis adjustment would give rise to depreciation and amortization deductions and reduced capital gains that together would allow AmerGen to reduce its taxable income by more than \$110 million per year. The IRS rejected AmerGen's position.

Although the amounts disputed changed over the course of litigation, both the court of claims and the Federal Circuit found that the economic performance requirement of section 461(h) precluded AmerGen from taking the liabilities into account until it actually performed the decommissioning services that would give rise to them. The Federal Circuit began its analysis by acknowledging the rule of *Crane* and its progeny: "Courts have extended the holding of *Crane* and determined that, under certain circumstances, the basis of an acquired asset includes, not only the purchase price, but also noncontingent liabilities assumed by the buyer or encumbering the asset."[24] From there, however, the court noted that the liability of an accrual-method taxpayer is "deemed incurred when all events have occurred that determine the fact of liability and the amount of that liability with reasonable accuracy."[25] It quoted section 461(h)(1) and (4):

> (1) In general. *For purposes of this title*, in determining whether an amount has been incurred *with respect to any item* during any taxable year, the *all events test* shall not be treated as met any earlier than when economic performance with respect to such item occurs. . . .
>
> (4) All events test. For purposes of this subsection, the *all events test* is met *with*

[21] Reg. section 1.461-1(a)(2)(ii).

[22] *AmerGen*, 113 Fed. Cl. 52.

[23] *AmerGen*, 779 F.3d at 1368.

[24] *Id*. at 1372-1373.

[25] *Id*. at 1373.

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> *respect to any item* if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.[26] [Emphasis added by court.]

AmerGen argued that the all-events test under section 461(h) did not apply in calculating purchased assets and that *Crane* and its progeny require only that a liability be noncontingent and definite. The Federal Circuit held otherwise. In finding that section 461(h) did indeed apply to AmerGen, the court looked to the rules of sections 468A and 172(f), which provide a specific statutory scheme governing contributions for nuclear decommissioning costs and loss carrybacks, and found that to disregard section 461(h) would circumvent that scheme. Moreover, the court noted that section 461(h)(1) "plainly states that it applies for all 'purposes of this title,' *i.e.*, the Internal Revenue Code."[27]

The Federal Circuit concluded that the decommissioning liability was a service liability, thereby triggering application of the rule of section 461(h)(2)(B), which governs services and property provided by the taxpayer: "If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services." In holding that the decommissioning liabilities could not be included in basis, the court noted that none of the three plants were decommissioned as of the tax years at issue (2001-2003), and further that those plants might not be fully decommissioned until as late as 2106. It further noted that AmerGen had sought private letter rulings on the matter, and that the IRS had ruled that the company would "not be entitled to treat as a component of its cost basis . . . any amount attributable to the future decommissioning liability" at the time of the acquisition because AmerGen would not have any decommissioning services. Thus, the liability would not yet be incurred for tax purposes under section 461(h).[28]

AmerGen asserted that if section 461(h) applied at all, the liability should be one arising from the transfer of property under section 461(h)(2)(A)(ii). The Federal Circuit disagreed because the liabilities were a "service to be provided *by* the taxpayer, not a property provided or a service to be provided *to* the taxpayer."[29] (Emphasis added.)

IV. *Oxford Paper* and Section 461(h)

What is the relationship between the economic performance requirement of section 461(h) and the *Oxford Paper* line of authority allowing the assignee of an underwater lease to take into account the lease obligations both as an offset to cash received and in determining the basis of any property transferred in consideration of the assumption? The *AmerGen* decision does not acknowledge *Oxford Paper* or Rev. Rul. 55-675. And *AmerGen*'s central holding that the economic performance requirement applies for purposes of taking into account liabilities incurred in an acquisition is at first blush hard to reconcile with *Oxford Paper* and Rev. Rul. 55-675. Yet interestingly, many of the nuclear decommissioning rulings that preceded *AmerGen* (the reasoning of which was adopted by the *AmerGen* court in its decision) discuss *Oxford Paper* and Rev. Rul. 55-675 and rely on those authorities.

For example, LTR 200243022 (discussed above), in examining whether the buyer's receipt of the decommissioning funds in the transaction creates immediate taxable income to the buyer, cites *Oxford Paper* and Rev. Rul. 55-675 for the following proposition:

> A taxpayer generally does not realize gross income upon its purchase of a business' assets, even where those assets include cash or marketable securities and, in connection with the purchase, the taxpayer assumes liabilities of the seller. See *Commissioner v. Oxford Paper*, 194 F.2d 190 (2d Cir. 1952); Rev. Rul. 55-675, 1955-2 C.B. 567. In this case, Buyer cannot acquire the Plant without assuming the decommissioning liability, which is inextricably associated with ownership and operation of Plant, and there is no

[26] *Id*.

[27] *Id*. at 1374.

[28] *Id*. at 1370-1371.

[29] *Id*. at 1375-1376.

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> indication that the transaction is other than a bona fide purchase of the business and its associated assets and liabilities.[30]

So how, then, does one reconcile the coexisting assertions by the IRS that (1) *Oxford Paper* and Rev. Rul. 55-675 remain the rule of law such that a taxpayer does not realize gross income upon receipt of cash from a seller in an acquisition in which it assumes the seller's liabilities, yet (2) those liabilities cannot be accounted for in basis until some future action by the buyer has occurred in accordance with section 461 regulations? The answer provided in LTR 200243022 (somewhat confusingly) is as follows:

> Buyer will not realize income from its purchase of the Plant and Seller's interests in the assets in the decommissioning funds. The Buyer will realize income from its purchase of the Plant and related assets to the extent that the amount of cash and other Class I assets (as defined in section 1.338-6(b)(1)) received exceeds its total cost determined under section 1012 (which will be the sum of its cash consideration and the fair market value of any other consideration it provides to Seller that is, under applicable tax principles, taken into account on the date of the applicable asset acquisition). If Buyer is thus required to take an amount into account as income, then, when, under general principles of tax law, Buyer is permitted to take additional consideration into account (e.g., when it satisfies the economic performance requirement with respect to the decommissioning liability assumed), Buyer will be entitled to deduct currently (and will not be required to capitalize) such amount. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

In other words, the economic performance test must be applied first to determine whether an assumed obligation is treated as having been incurred under the all-events test. Any liabilities that are treated as incurred under those rules are then accounted for under *Oxford Paper* and will shield the taxpayer from recognizing income from cash received. If a liability is not treated as incurred because the economic performance test is not met as of the acquisition date, however, cash received is taxable and the taxpayer gets a deduction when the liability is ultimately incurred in the future. To the extent that the taxpayer received property other than cash (or other Class I assets), any liabilities that are treated as incurred under section 461(h) give rise to immediate basis in those assets, while any liabilities not yet incurred under section 461(h) are not taken into account in determining basis until the economic performance test is satisfied for those liabilities.

A. Underwater Leases

AmerGen and the nuclear decommissioning rulings involved liabilities that required the taxpayer to provide services. They are therefore governed by the section 461(h)(2)(B) rule that defers economic performance until the services are provided.[31] How should the economic performance requirement be analyzed in the original *Oxford Paper* fact pattern, in which the taxpayer assumes an underwater lease and is not providing services? Lease obligations in general fit more squarely within section 461(h)(2)(A)(iii) and reg. section 1.461-4(d)(3), which provide that if the liability of a taxpayer arises out of its use of property, economic performance occurs as the taxpayer uses the property. Under this rule, rental expenses are generally treated as incurred ratably over the period to which the rental payment obligation is attributable.[32] Consistent with the foregoing, even under *Oxford Paper*, if one were to assume a lease at fair value, the lease payments would simply be the payments for use of the property, deductible when paid over the course of use, and not a special assumed liability to be accounted for in basis. So for a fair value lease, section 461(h)(2)(A)(iii) should apply.

But should the *entirety* of the lease acquired by the purchaser be understood that way if the seller

[30] Other private letter rulings on nuclear decommissioning set forth the same analysis referencing *Oxford Paper*. *See, e.g.*, LTR 200546037.

[31] Reg. section 1.461-4(d)(4) further treats this requirement as satisfied when the taxpayer incurs the cost of providing the services.

[32] *See* reg. section 1.461-4(d)(7), examples 6 through 9.

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pays for its assumption? Rationally, the answer seems to be no. The underwater portion of a lease assumed by an assignee for consideration cannot logically be understood to have been assumed as consideration for use of the leased property. Rather, that portion of the lease obligation has been assumed as consideration for the property transferred to the assignee by the assignor. As such, the underwater portion of the lease is more properly understood as a liability arising from property having been transferred to the assignee, which would be governed by section 461(h)(2)(A)(ii) and reg. section 1.461-4(d)(2)(i). Under the rule for those liabilities, economic performance occurs as the property is provided to the taxpayer. Thus, the economic performance rules arguably should support a bifurcation of the assumed lease, with the negative value of the lease being treated as a separate liability incurred by the assignee upon receipt of the cash or property from the assignor. The balance of the payments due under the lease would be treated the same way they were treated in the hands of the original lessee-assignor — namely, as costs to be incurred in the future over the term of the lease.

Is there any authority to support the bifurcation of a lease assumption transaction in this fashion? One potential source of authority is a 2001 IRS field service advice memorandum: FSA 200152002. The memo involves a variation of a lease-stripping transaction, in which the taxpayer had an expiring capital loss and the transaction was structured to generate a capital gain rather than a loss.[33] The taxpayer acquired a promissory note and rights to use equipment in exchange for a nominal amount of cash and the assumption of lease obligations. The taxpayer took the position that its basis in the promissory note was equal to the amount of cash it paid. It then claimed a capital gain on a subsequent exchange of the note for a different note with a similar principal amount. Although the field service advice addresses sham transactions and other issues, it also concludes that no gain was properly realized because the basis in the note included the obligations assumed by the taxpayer under the lease and that the negative value of the lease was implicitly equal to the full FMV of the note received by the taxpayer.

In analyzing the applicable treatment of the assumed lease obligation, the IRS looked to both *Oxford Paper* and Rev. Rul. 55-675 to determine if the assumed lease obligation was properly taken into account in determining the cost of acquiring the promissory note. But FSA 200152002 applies *Oxford Paper* without expressing any concern for, or even referring to, the potential application of the economic performance doctrine of section 461(h). The most plausible explanation for this omission in what is otherwise a thoroughly reasoned discussion of the relevant law is that the IRS was comfortable that the economic performance requirement was the rule under section 461(h)(2)(A)(ii) because the obligation was assumed in consideration for the transfer of the note to the taxpayer.

The potential for bifurcating a single lease between the same two prongs of the economic performance test to treat a portion of the lease as a liability incurred for property used by the taxpayer and the rest as incurred in consideration for property provided to the taxpayer was addressed in ILM 200528024. The internal legal memorandum considers a lease-stripping transaction in which, through a series of transactions, Corp. A acquired from Corp. B several promissory notes in exchange for assumption of B's master lease obligations. During the initial period of the master lease, the leased property was subject to subleases to parties that were entitled to use the property during the term of the subleases. In subsequent years, the user leases terminated, and A would have use rights in addition to lease obligations. Further, B's assignment of the master lease obligations to A caused the lease payment obligations to accelerate.

In addressing whether the taxpayer could include the assumed lease obligation in its basis, the memo points to section 461(h)(2)(A)(ii) on the one hand — which says that if a liability arises out of the provision of property to the taxpayer by another person, performance occurs when that property is provided to the taxpayer — and to section 461(h)(2)(A)(iii) on the other hand —

[33] The strategy was apparently to use the gain that the loss sheltered to create a high-basis promissory note and then to use the proceeds from that note to make an offsetting deductible lease payment, thereby "refreshing" the loss and converting it into an ordinary loss.

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providing that if the liability arises out of the taxpayer's use of the property, performance occurs as the property is used. ILM 200528024 proposes that the lease obligations be bifurcated between the initial period when the use was reserved to the sublessees and the period for which the taxpayer was entitled to the use of the leased property. The memo further argues that A's assumed lease obligations for the period without use rights resulted in immediate basis in the acquired promissory notes (the transferred property) but that the rental obligations for the period when A would have use rights would be incurred only as the use occurred.[34]

Perhaps the strongest support for the bifurcation approach in the underwater lease assignment context comes from *Oxford Paper* itself. *Oxford Paper* (and Rev. Rul. 55-675) permitted the taxpayer to include the negative value of the lease in its basis, but the decision is explicit that the balance of the lease obligations assumed by the taxpayer (representing an FMV rental) would not be includable in the taxpayer's basis. Although the section 461(h) economic performance rules did not exist when the case was decided, implicit in the court's decision is a clear recognition that those future rental payments cannot be taken into account before being paid or accrued in the normal fashion. In drawing a distinction between the FMV rental obligation and the excess rent above FMV, the decision recognizes that the excess rent is being assumed by the taxpayer only in exchange for the property it receives from the seller and not in exchange for the right to use the property, and as such warrants different tax treatment.

It is worth pausing to ask whether a similar argument would be appropriate in the nuclear decommissioning liability context. That is, couldn't the purchaser of a nuclear power plant be viewed as assuming the decommissioning liability in consideration for the transfer to the purchaser of the nonqualified decommissioning reserve fund, in which case the liability would be subject to section 461(h)(2)(A)(ii) and thus eligible for immediate accrual? The taxpayer in *AmerGen* made this argument, but the court, without directly responding to the argument's reasoning, held that the liability is more appropriately viewed as a liability to provide services. In support, the court pointed to Example 1 of reg. section 1.461-4(d)(7), which concludes that a taxpayer that enters into a contract requiring it to remove an oil drilling platform is subject to section 461(h)(2)(B) rather than section 461(h)(2)(A)(ii). In truth, the liability is both a liability to provide services and a liability incurred for consideration, but it appears from that example that the intent of the regulations is for dualistic liabilities to be governed by section 461(h)(2)(B). The court also could have pointed to the rule for barter transactions in reg. section 1.461-4(d)(4)(ii), which explicitly addresses situations in which a taxpayer receives property in consideration for taking on a liability to provide a service. The rule for those transactions is instructive because it provides that economic performance occurs only to the extent of the lesser of the property received by the taxpayer and the costs incurred by the taxpayer.

B. Section 467 Leases

What if, rather than a seller's paying consideration to a buyer for assuming an underwater lease, the seller makes a prepayment of rent to the lessor so that the remaining rent under the lease reflects the current market value? Suppose a circumstance in which a buyer plans to purchase an entire business for $1 million — the agreed-on value of its assets less its liabilities, aside from the business's remaining obligations under a lease. The business includes a lease with a remaining term of five years and payments due in equal monthly installments, the remaining obligations under which have a present value of $4 million in total. Assume that the rental market has shifted from the time the lease was entered into, such that a new lease entered into on the date of the sale would provide for payments with a present value of $2 million. Accordingly, the remaining term of the lease is underwater by $2 million. Instead of paying the buyer $2 million to

[34]The IRS expressed some uncertainty about this analysis and argued, in the alternative, that if section 461(h)(2)(A)(ii) were inapplicable and the lease obligations for the initial non-use period were governed by the payment rule of section 461(h)(2)(D) and reg. section 1.461-4(g)(7), the taxpayer could still include them in its basis in the acquired promissory notes in the year of acquisition because the payment was accelerated by the assignment of the lease. Regardless, the chief counsel advice would have bifurcated the lease obligations for the use and non-use periods.

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assume the underwater lease, the seller could prepay to the lessor \$2 million (that is, the underwater portion) of the \$4 million lease, such that the present value of the remaining payments assumed by the buyer would be \$2 million (that is, its fair value at the time of the transaction).

What is the effect of the seller's prepayment of the \$2 million on the lease? The prepaid rent should create a so-called 467 lease under section 467 and its regulations.[35] A rental agreement has prepaid rent for purposes of section 467 if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year under reg. section 1.467-1(c)(3)(ii). The rules under section 467 and reg. section 1.467-2 create a deemed section 467 loan to the lessor. Under the section 467 regime, the lessor generally does not take the prepaid rent into income until the periods to which that rent is allocable under the lease's terms under reg. section 1.467-1(c)(2)(ii), and interest is then imputed on the deemed section 467 loan at 110 percent of the applicable federal rate under reg. section 1.467-2(c).[36] Correspondingly, the lessee is not entitled to deductions for the rent until payments would have been due as well, such that the timing for the income and deductions of the lessor and lessee matches.

If a lease under which there is a section 467 loan is assigned by a lessee to a substitute lessee (here, the assignment of the lease from the seller to the buyer), the assignee steps into the shoes of the lessee for purposes of claiming deductions associated with the prepaid rent and determining the section 467 loan interest and balance. So if the seller were to prepay \$2 million of rent immediately before the sale of the business to the buyer, the rental deductions associated with the prepaid rent would belong to the buyer. Under reg. section 1.467-7(f)(2)(iv), if the principal balance of the section 467 loan is negative (that is, the lessee has prepaid rent), any repayments deemed received by the substitute lessee from the lessor (in the form of an offset to the rent allocable to a future period) is treated as an item of gross income of the substitute lessee that offsets the rental deduction for future periods and effectively reduces the substitute lessee's net rental deductions to the amount of rent actually payable in future periods.

The net economics for each of the lessor, seller, and buyer in the 467 lease scenario are similar to those in the *Oxford Paper* fact pattern, in which the seller pays the buyer to acquire the full underwater lease. In each case, \$2 million has been set aside to cover a portion of the future rent payable under the lease. The only difference between the two scenarios is that in the first, the buyer holds the cash that it will need to service the rental payments, and in the second, the cash is held by the lessor. Accordingly, the approach under the *Oxford Paper* line of authorities, which treat the payment to the assignee as an offset to future rent, seems appropriate because it is entirely consistent with the section 467 rules that likewise treat the seller's prepayment as an offset to future rent.

While the 467 lease might provide a solution and extra peace of mind to the buyer, it reinforces the principle for which *Oxford Paper* stands: Liabilities assumed in connection with the acquisition of a business should be treated as part of the buyer's purchase price. The 467 lease analogy makes it clear that the *Oxford Paper* transaction is in no way abusive; rather, it reaches essentially the same tax result on the same economics as would be achieved by prepaying rent and creating a 467 lease to facilitate the overall transaction.

C. Prepaid Subscription Authorities

A related line of authorities that should be distinguished from *Oxford Paper*, Rev. Rul. 55-675, and the nuclear decommissioning rulings addresses the treatment of acquisitions involving prepaid subscriptions. Rev. Rul. 71-450, 1971-2 C.B. 78, concludes that cash paid by a seller to a purchaser for assuming the obligation to deliver

[35] Section 467 does not explicitly refer to prepaid rent, but the regulations have construed it to include prepaid rent.

[36] A full discussion of the computations required under section 467 in a prepaid rent scenario is beyond the scope of this report, but suffice it to say that the rules are complex.

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prepaid subscriptions for which the seller was obligated results in taxable income to the purchaser.[37] Under the facts addressed by the ruling, the seller sold its newspaper business to the purchaser. The purchaser paid the seller for the acquisition of its business, but under the same agreement, the seller also paid the purchaser cash for the business's liability for unearned subscriptions (that is, payments ran in both directions).

Rev. Rul. 71-450 has been cited favorably by several private letter rulings.[38] Generally, these rulings seem to suggest that the reason for the conclusion in Rev. Rul. 71-450 is that the purchaser received a separate cash payment for the prepaid subscriptions, and that the purchase price for the acquisition of the broader business didn't reflect inclusion of those liabilities.[39] Many of the rulings relate to the nuclear decommissioning funds and distinguish their facts from Rev. Rul. 71-450; they describe Rev. Rul. 71-450 as an exception to the rule of *Oxford Paper* that "generally, a taxpayer does not realize income upon its purchase of a business' assets, even where those assets include cash or marketable securities and, in connection with the purchase, the taxpayer assumes liabilities of the seller."[40] A possible rationale for that exception could be that Rev. Rul. 71-450 reflects an early determination by the IRS that the obligation to deliver the newspapers to the subscription holders is a service obligation that is not appropriately treated as a liability until the service is performed, akin to the position ultimately adopted by Congress in section 461(h)(2)(B) and by the Federal Circuit in *AmerGen*. Yet another way to explain the result in the prepaid subscription situation is that section 455 actually does allow the purchaser to elect to amortize the prepaid subscription income, and that Congress intended for this election to replace any reserve for the liability to deliver the subscriptions.[41] In any event, these rulings appear to be a special case from which one should be hesitant to draw analogies.

V. Amortizing *Oxford Paper* Liabilities

It is unclear from *Oxford Paper* or Rev. Rul. 55-675 how a buyer that treats an amount received from the seller as payment for an assumed liability under an underwater lease accounts for the amortization of the assumed liability. Clearly, it would be inconsistent for the buyer to simply deduct all its future lease payments as ordinary and necessary business expenses after excluding from income the cash it received to pay those expenses. Some portion of the future rental payments must be treated as an assumed liability payment, which does not give rise to a deduction, but there is no guidance on how the assumed liability is apportioned among the remaining payments due under the lease. One reasonable approach would be to amortize the assumed liability under a straight-line method over the remaining term of the lease (for example, 20 percent per year if there are five years remaining on the lease term). Another approach would be to amortize the liability ratably in proportion to the amount of rent due each year (for example, if the rent under the lease for the first year of the remaining five-year term represents 15 percent of the total rent payable, 15 percent of the assumed liability would be amortized that year). Alternatively, if the rent payable on the lease is significantly uneven, it may be more appropriate to amortize the assumed liability in a manner that levels the annual deductions for rent payable under the lease.

VI. Treatment of the Seller

While the treatment of the seller is not the focus of this report, it certainly merits consideration and will drive in part the negotiation of an acquisition. Although it seems abundantly clear that the seller ought to be able to take a deduction for cash that it pays to the buyer

[37] *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964), holds that the seller in the same fact pattern is required to include any amounts it deferred under section 455 in its income at the time of the sale because "when the reasons for the establishment of the reserves and their tax deferral cease to exist, the taxability which had been deferred should forthwith mature." However, the court noted that the inclusion is effectively nullified by an offsetting deduction or offset to the purchase price.

[38] *See, e.g.*, LTR 8749076 and LTR 8612050.

[39] *See, e.g.*, LTR 200107007 and LTR 200034008.

[40] *See* LTR 200107007 and LTR 200034008.

[41] *See* LTR 8749076 (treating the purchaser as receiving a prepaid subscription eligible for the section 455 deferral election).

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to assume an underwater lease, the question of *when* that deduction may be taken could be of consequence to the seller. In the ordinary course, a lessee generally deducts rent when it is paid and not sooner (regardless of whether the lease is above or below market). In the case in which the seller pays the buyer to assume the lease, must the seller wait to deduct that amount until the buyer pays rent in accordance with the lease's schedule? Or may the seller take the deduction as soon as the transfer of the lease is consummated?

Reg. section 1.461-4(d)(5)(i) addresses liabilities that are expressly assumed[42] by the buyer:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See section 1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

The regulation clarifies when economic performance occurs for the liability — namely, at the time the liability is "properly included in the amount realized on the transaction" by the seller — and in so doing, it seems to presuppose that liabilities assumed by a buyer in that circumstance are included in the seller's amount realized on the sale under reg. section 1.1001-2.

Reg. section 1.1001-2(a)(1) provides as a general matter that the amount of liabilities from which a seller is discharged in a sale is included in the seller's amount realized. When a seller is paying cash to the buyer in the underwater lease assumption scenario, the seller should have an offsetting deduction for the amount of that payment under reg. section 1.461-4(d)(5)(i). Reg. section 1.461-4(d)(5)(i) appears to operate to trigger simultaneously the inclusion in amount realized and the deduction for the same amount, allowing the seller to take that deduction at the time of the transfer of the lease rather than wait for the buyer to pay rent under the lease and to take deductions concurrently with rental payments (that is, when the seller would have taken deductions had it not transferred the lease).

The Tax Court reached a substantively similar result in *Commercial Security*,[43] which addressed an asset sale in which the buyer had assumed some accrued but unpaid liabilities. The case predated the enactment of section 461(h), but its mechanics suggest that a similar result would and should be reached under reg. section 1.461-4(d)(5)(i) today. In *Commercial Security*, the parties agreed that the seller was obligated to recognize all items of income accrued before the date of sale, but the IRS disputed that the seller could take deductions for liabilities accrued before the sale but not yet paid. The court determined that the seller was indeed entitled to a deduction for the accrued but unpaid liabilities at the time of sale because the purchase price had been reduced by those amounts such that it was as if the seller had in fact paid those amounts to the buyer at the time of the sale. Today, reg. section 1.461-4(d)(5)(i) appears to permit explicitly the same deduction that *Commercial Security* allowed, by looking to the reduced purchase price as constructive payment of proceeds from the seller to the buyer. The fact that the seller is entitled to the benefit of this provision only upon sale of its business ought to

[42] It is unclear what "expressly assumed" means in the context of this regulation, and whether it means that the liability assumption must be separately specified or whether the buyer's assumption of all the seller's liabilities in the transaction (as long as it is expressly stated that all liabilities will be assumed) suffices. Arguably, the latter is more logical, and "expressly assumed" may be intended to differentiate between liabilities assumed deliberately by the buyer and factored into the purchase price versus those the buyer may inherit through successor liability rules, for example. *See, e.g.*, Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, para. 304.4 (Dec. 2020). Given the ambiguity, it may be prudent for a seller seeking to avail itself of this regulation to itemize the liabilities that the buyer will assume and to ensure that the assumption is expressly stated in the transaction documents.

[43] *Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981).

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prevent the timing abuses that section 461(h) was designed to curb.[44]

Consider the following examples.

Example 1: *Assets exceed liabilities*. A buyer acquires the seller's business, consisting of assets worth $2 million, for $1 million cash and the assumption of a liability in the amount of $1 million. (Assume the liability is of a sort that would give rise to an ordinary deduction but that economic performance has not occurred before the sale, and for simplicity, assume that the seller's basis in the business is $0.) The seller would recognize $2 million of gain (which may be capital or ordinary, depending on the nature of the asset) and would be entitled to an offsetting ordinary deduction of $1 million for the liabilities under the rule of reg. section 1.461-4(d)(5)(i). The seller would be in the same net tax position (timing difference aside) if it sold the assets for $2 million and retained and separately paid the outstanding liabilities of $1 million, thereby generating a $1 million deduction, which seems to be the appropriate result.

Example 2: *Liabilities exceed assets (underwater business).* A buyer is acquiring the seller's business in a cash transaction, with assets worth $500,000 and a liability of $1 million. (Assume the liability is of a sort that would be deductible but that economic performance did not occur before, and for simplicity, assume that the seller's basis in the business is $0.) The purchase price would be adjusted to -$500,000, such that the seller would be paying $500,000 to the buyer. The seller should recognize $500,000 of gain (likely capital, depending on the assets sold) but should be entitled to a $1 million deduction for the assumed liabilities under the rule of reg. section 1.461-4(d)(5)(i). The seller would have been in the same net tax position (timing difference aside) if it had sold the assets to the buyer for $500,000 (such that the buyer was paying the seller) and the seller retained and separately paid the liabilities of $1 million, generating a $1 million deduction.

Ostensibly, under the rule of reg. section 1.461-4(d)(5)(i), the tax impact on the seller of the buyer's assumption of the seller's liability should be consistent, whether a business is underwater or not (that is, regardless of the direction in which cash flows between the two parties to the acquisition).

A lease raises more conceptual complexity than the traditional assumed liability in an acquisition. The distinction between a lease and many other liabilities acquired in an acquisition is that a lease is not pure liability or asset. Hypothetically, every lease at any moment is *in part* either an asset or a liability to its tenant (and to its lessor, although not the subject of this report) because the rent is either above or below market value, unless at that moment the lease happens to be precisely at market value. But the lease is not *in whole* an asset or liability: Some part — and probably most — of the payments due under the lease constitute fair value for the right to use the property. Further, the components of a lease itself, including a lease at fair value, are economically part asset and part liability: part a right to use, part an obligation to pay. A service contract might have the same qualities as a lease, for example, so the lease is not entirely unique in this character. For tax purposes, however, those separate components are ignored.

It is only when a lease is transferred between parties that the extent to which it is an asset or liability — because a party will either pay to acquire it or be paid to assume it — for tax purposes crystalizes. The resultant tax consequences are determined by the parties' arm's-length willingness to pay consideration for its transfer. In this sense, the lease is not so different from other transferred property between arm's-length third parties, in which tax law does not attempt to determine an independent fair value but rather respects the price set by the parties in determining the generation of a deduction or a recognition of gain. The same should hold true for a lease transfer: To the extent that the rent is at fair value, no consideration changes hands, and no tax consequences result from the transfer. In the circumstance that arose in *Oxford Paper* with an underwater lease, a portion of the lease — namely, the amount by which the deal price is adjusted — would become a liability

[44] A related question, less favorable to the seller than the general rule of reg. section 1.461-4(d)(5)(i), is whether the seller must recognize any discharge of indebtedness income in an acquisition. Indeed, that regulation says: "See section 1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange."

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"expressly assumed," triggering the mechanics of reg. section 1.461-4(d)(5)(i) and thus an inclusion in amount realized for the assumed liabilities and an offsetting deduction for the seller. The balance of the assumed lease would be the fair value portion, for which no liability is expressly assumed by the buyer. No inclusion should be incurred, nor should the seller seek a deduction.

VII. Conclusion

At first blush, it might appear that the section 461(h) economic performance requirement coupled with the nuclear decommissioning authorities would necessarily supplant or modify the rule of *Oxford Paper* such that assumed liabilities on an underwater lease and a payment running from the seller to the acquirer could create taxable income for the acquirer. A closer analysis, however, suggests that this is not the case. Rather, the economic performance requirement under section 461(h) and the nuclear decommissioning authorities can be reconciled with the rule of *Oxford Paper* because the obligations assumed by an acquirer of an underwater lease are not service liabilities of the acquirer for which future performance of services are required for the obligations to be recognized under the economic performance rules. To be sure, key questions remain unanswered regarding the treatment of assumed liabilities under a lease, such as proper amortization of the liability and the treatment of the seller in the transaction. Yet the fundamental premise of *Oxford Paper* and its progeny protecting a purchaser from taxable income in those circumstances should still be good law. ■

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