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ACCOUNTING FOR ADVANCE PAYMENTS IN ACQUISITIVE TRANSACTIONS

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Receipt of an advance payment for goods or services generally results in taxation of the income at the time of receipt, but, in some circumstances, income recognition may be deferred. The advance payment also arguably creates a liability that is satisfied upon the recipient fulfilling its contractual obligation to deliver goods or perform services. A great deal of controversy surrounds the tax consequences of the assumption by a buyer of the obligation associated with an advance payment as part of the sale of assets that constitutes a trade or business. First, it is not clear under current authority what the tax consequences of the assumption of that liability by the buyer are. A second issue relates to whether and when the seller and the buyer should recognize income from an advance payment. The character of the obligation related to an advance payment and the tax consequences of transferring the obligation as part of an asset sale of a business are explored in this article. The article concludes that the uncertain tax consequences result from insufficient and inconsistent guidance and proposes alternatives the Department of the Treasury and the Internal Revenue Service should consider for issuing regulations.

INTRODUCTION

In business transactions, compensation generally follows performance—that is, the provider of goods or services delivers goods or performs services first and compensation follows. It is not uncommon, however, for this natural flow to be disrupted with the provider receiving all or part of its compensation before delivering any goods or services. For example, substantial costs may need to be

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incurred before the required goods or services can be delivered, in which case the provider may need compensation upfront to have the necessary resources. Or, goods may be unique and specially produced for a customer; if the customer cancels its order, the producer could lose all its production costs because the items cannot be sold to other customers.

Payments received for goods and services before their delivery are known as "deferred revenue." They are also called "unearned income," especially in financial accounting jargon, and, in the world of taxation, they are "advance payments." Regardless of the term used, accounting for these payments is not complicated or controversial under normal circumstances. Both generally accepted accounting principles (GAAP) and tax law prescribe guidelines as to the timing and amount of income inclusion. For tax, complications arise when, as part of an acquisitive asset transaction, the advance payments and other assets and related obligations and liabilities, are transferred from the seller of the business to the acquirer. Tax rules in this area are riddled with controversy and inconsistencies that can result in different tax consequences, depending on the structure of a transaction.

This article explores the character of the obligation related to an advance payment and the tax consequences of the transfer of the obligation as part of an asset sale of a business. Part I provides an overview of the accounting and tax rules for deferred revenues by the recipient of an advance payment. The tax issues for the buyer and the seller in the transaction are discussed in Part II, demonstrated through a hypothetical example of a sale of business assets. In Part III, two alternative approaches for determining the tax consequences to the buyer and seller are discussed and applied to the hypothetical example. Finally, Part IV examines the prospect of receiving future guidance to resolve the tax treatment of transfers of deferred revenues and proposes solutions that would resolve some of the controversies. The article concludes that the Department of the Treasury (the Treasury) and the Internal Revenue Service (IRS) should issue guidance that addresses the unresolved issues.

I. TAX AND ACCOUNTING TREATMENT OF ADVANCE PAYMENTS

Under GAAP, the obligation created by the receipt of payments in advance of the provision of goods or services is treated as a liability ("deferred revenue").[1] Tax law similarly treats such obligation as a liability.[2] The receipt of deferred revenue is similar to a loan transaction. When a taxpayer borrows money, it receives cash, along with an obligation to repay the debt. In the case of deferred revenue, the recipient of the payment is obligated to perform services or deliver goods; a failure to perform the obligation has financial consequences to the obligee. The obligation created by the receipt of an advance payment is thus treated as a liability for tax purposes since the obligation is no less a liability than an obligation to repay

[1] *See* FASB ASC 430-10.
[2] Rev. Rul. 76-520, 1976-2 C.B. 42; James M. Pierce Corp. v. Comm'r, 326 F.2d 67, 70 (8th Cir. 1964).

a loan.[3] Under both scenarios, relief from the liability would generally result in recognition of income to the taxpayer.[4]

There is a major functional difference between deferred revenue liabilities and other types of financial obligations: deferred revenues ultimately will be recognized as income. Unlike a loan transaction, the taxpayer does not discharge its obligation by repaying the advance payment; instead, the taxpayer will deliver the goods or services under its contractual obligation so it can "earn" the "unearned" deferred revenues. For both GAAP and tax purposes, the taxpayer will eventually recognize income from an advance payment, although the timing is not always the same under the two regimes.[5]

GAAP does not allow recognition of revenue for goods or services until "the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer."[6] Therefore, an entity can receive payments in advance for a promise to deliver goods or services in the future but defer the inclusion of the amount received as revenue in its financial statements until a subsequent year when its performance obligations are met. An "advance payment" is defined, for tax purposes, as any payment that the taxpayer is permitted to include in its gross income in the year it is received if any portion of that payment is included in revenue by the taxpayer in its financial statement for a subsequent year.[7] This definition creates some equivalence between those payments defined as advance payments for tax purposes and those treated as deferred revenue under GAAP. This consistency, however, does not extend to the timing of inclusion of the payments in income, and income may be recognized for tax purposes before it is reported on financial statements, leading to a temporary book-tax difference.[8] Section 451(c) allows a taxpayer to either include advance payments in its gross income in the year received or elect to defer income recognition until a future year if certain conditions are met. Such deferral would not apply to a cash-basis taxpayer, who must include all advance payments in its gross income in the year of

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[3] A liability is defined as "the quality, state, or condition of being legally obligated or accountable; legal responsibility to another, or to society, enforceable by civil remedy or criminal punishment." In terms of its financial connotations, a liability is defined as "a financial or pecuniary obligation in a specified amount." *See Liability*, BLACK'S LAW DICTIONARY (10th ed. 2014).
[4] I.R.C. § 61(a)(11). Section 108 provides exceptions to this general rule.
[5] For GAAP recognition rules related to deferred revenue, *see* the transitional guidance in FASB ASC 606-10-25. For tax recognition rules, *see* I.R.C. § 451(c) and regulations issued in T.D. 9941, 86 Fed. Reg. 810 (Jan. 6, 2021).
[6] FASB ASC 606-10-25-4.
[7] I.R.C § 451(c)(4); Treas. Reg. § 1.451-8(a)(1). Advance payments include amounts received for services, sale of goods, and certain related licensing arrangements, but exclude payments received for rents, insurance premiums, interest, and financial instruments and arrangements. I.R.C § 451(c)(1)(B).
[8] Section 451(b), enacted as part of the Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97, § 13221, 131 Stat. 2113 (2017)), generally requires recognition of income for tax purposes no later than when the income is recognized on the "applicable financial statements" of the taxpayer. Thus, it is generally not possible for deferred revenues to be reported on financial statements prior to inclusion in income on the tax return.

actual or constructive receipt.[9] In addition, income from advance payments can be deferred only to the extent such payments are not included in its financial statements in the year of receipt.[10] Finally, unlike GAAP, the deferral is limited to one taxable year beyond the year in which the advance payment is received.[11]

II. TRANSFER OF DEFERRED REVENUE LIABILITIES

Business asset acquisitions generally involve the transfer of many assets and liabilities. The negotiated price between the buyer and the seller is driven primarily by the value of the assets and the liabilities. The valuation of assets and liabilities, in isolation and in the aggregate, can be a complicated and subjective process and must consider the contractual rights and restrictions on the obligations being transferred, such as the right to assign or rescind the underlying contracts and termination rights and obligations. Deferred revenue obligations, created by the receipt of advance payments by the seller of the business assets, may be among the obligations transferred to the buyer. Regardless of whether the seller has previously recognized income, so long as the contractual obligation created by the receipt of an advance payment is not satisfied, the obligation is a liability.

The tax consequences to the parties to the sale are best illustrated through an example with a deliberately oversimplified set of facts. Assume that Sue Seller, an accrual-basis taxpayer, is a CPA who has been in practice for many years and wants to retire and sell her practice. In anticipation of her retirement, Sue has collected all receivables, paid all bills, and liquidated all other assets. The only asset to be transferred is goodwill, which has a fair market value of $1 million.[12] She receives an offer of $1 million from Bob Buyer, CPA, who also uses the accrual method for tax purposes.

Before the sale is finalized, a potential client approaches her about an engagement to audit one of his businesses for $100,000, all of which would be paid upon signing a contract. Motivated by the cash offer and the potential additional exit value of her business, Sue signs a binding, noncancellable contract for the engagement and deposits the advance payment in her business bank account. Sue elects under § 451(c) to defer the inclusion of the advance payment in her gross income. After signing the contract for this new engagement, Sue discovers that, consistent with industry practices, a reasonable price for such an engagement would have been $150,000. Were she to perform this audit, Sue would have done all the work herself for a fee of $150,000. Thus, instead of creating additional value for her business, she has burdened her business with an unfavorable contractual agreement.

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[9] I.R.C § 451(a); Treas. Reg. § 1.446-1(c)(1)(i).
[10] I.R.C § 451(b).
[11] I.R.C § 451(c)(1)(B).
[12] "Fair market value" is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. *See, e.g.,* Treas. Reg. §§ 1.170A-1(c)(2), 20.2031-1(b), 25.2512-1; Elmhurst Cemetery Co. v Comm'r, 300 U.S. 37, 57 (1937).

Sue then consummates the sale of her practice to Bob, which now consists of goodwill worth $1 million and cash in the bank of $100,000. Bob realizes that buying the practice will result in an obligation to perform an audit that would typically generate $150,000. Although Bob also would perform this audit himself, he knows this commitment would take his time away from similar engagements on which he could earn the fair price of $150,000. Accordingly, Bob now offers to pay only $950,000 for Sue's practice, reducing the $1.1 million value of assets (cash and goodwill) by the $150,000 "cost" of the obligation to perform the engagement. Sue agrees to the sale, regretting her poor business decision in accepting the audit engagement that cost her a net reduction of $50,000 from the sales price of her practice.

Determining how Sue and Bob should treat the transfer of the advance payment in this business acquisition for tax purposes requires a review of the authorities for transfers of deferred revenue obligations.

A. *Buyer's Issues*

The buyer is presented with tax issues upon the acquisition of the assets of a business: allocation of consideration to assets, the amount of any deferred revenue liability, and income recognition. There is ambiguity in existing authorities and potential inconsistency in the application of the rules to taxpayers.

i. Asset Allocation

In a "business combination," GAAP requires the buyer to record all assets and liabilities at their fair values.[13] Thus, the buyer of a business with an advance payment would record both a liability for the unearned revenue and an additional asset received in exchange for the liability assumption at the time of the combination. For example, if a business with an unearned revenue obligation of $100,000 is acquired for a cash payment of $1 million, the acquirer would record total assets of $1.1 million and a liability of $100,000. The presumption would be that, absent the unearned revenue liability, the acquirer would have paid $1.1 million cash for those same assets. The amount of the deferred revenue liability is

[13] FASB ASC 805-20-30-1. For purposes of Topic 805, the term "business combination" is defined as "a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations." *See* FASB ASC 805-10-20, Glossary. Thus, while the asset sale described in this hypothetical is included in that definition, under GAAP the definition includes all types of business acquisitions wherein one entity gains control of another, the rules for accounting for the tax consequences of which may be substantially different from those discussed in this article.

its fair value, if determinable,[14] and the asset is recorded as goodwill under the residual method.[15]

The amount of the goodwill is the difference between the cash consideration paid to acquire the business and the excess of the fair value of its identifiable assets over its liabilities. Thus, treating the deferred revenue as a liability creates additional goodwill by reducing the net fair value of the identifiable assets.[16] This financial reporting reflects the fact that, in economic terms, the buyer has received an asset in the business acquisition, along with an obligation to perform services or deliver goods at its own cost (i.e., a liability). Consistent with general financial reporting principles, receiving the additional goodwill does not give rise to income, because it is burdened by a liability of an equal amount. When the buyer performs the required services or delivers the required goods, it will recognize the revenue associated with the asset, recording a debit to deferred revenue to extinguish the liability and a credit to a revenue account.[17] The additional goodwill is not affected by the performance of services and the recognition of revenue.[18]

The tax consequences to the buyer for assuming the deferred revenue liability mirror to some extent the financial accounting principles, although there are significant differences in the details and timing. Similar to GAAP, the target entity's liabilities assumed in the acquisition are included in the amount of consideration.[19] Section 1060 requires a residual allocation methodology wherein the total consideration is allocated among the acquired assets by reference to their fair market values, with any remaining amount allocated to goodwill.[20] The amount assigned to each asset may not be identical under GAAP and tax because of minor differences in the allocation methodologies used by the two regimes.[21]

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[14] FASB ASC 805-20-25-19; FASB ASC 805-20-30-9. As an example, the guidance under FASB ASC 805-20-30-9 posits that the value of a contingent liability for warranty reserves can often be estimated and should therefore be recorded at the estimated amount.

[15] FASB ASC 805-30-30-1.

[16] *Id.* The GAAP methodology is comparable to the residual methodology used to account for an "applicable asset acquisition" for tax purposes under § 1060. Although the mathematical formulas used in the computation of goodwill appear to be different for GAAP and tax, they produce the same result (except for any differences attributable to the details of the allocation methods).

[17] FASB ASC 606-10-25-1 and transitional guidance in FASB ASC 606-10-65-1.

[18] The amount of goodwill recorded on the books of an acquired entity generally does not change unless it is determined to be impaired. If impaired, goodwill is written down and an impairment loss is recognized on the financial statements in the year of impairment. *See* FASB ASC 350-20-35-1.

[19] Treas. Reg. § 1.338 -5(b)(1)(iii). The seller also includes the amount of those liabilities in its consideration amount (amount realized). Treas. Reg. § 1.338-4(b)(1)(ii).

[20] I.R.C. §§ 338(b)(5), 1060(a)(2); Treas. Reg. § 1.338-6.

[21] The tax allocation methodology under Regulation § 1.338-6 allocates total consideration between seven classes of assets based on their aggregate fair market values and further among the assets of each class in proportion to their relative fair market values. This may, in some circumstances, result in a different consequence from GAAP's across-the-board fair value allocation. In addition, while "fair value" is defined almost identically in GAAP to the tax definition of "fair market value," there are differences in isolated circumstances. Finally, GAAP and tax have different rules for including the transaction costs incurred in the total amount allocated to the assets. Because of these disparities

The timing of the measurement of the goodwill also differs. For tax purposes, although deferred revenues are liabilities,[22] they are not "taken into account" at their acquisition date. "A liability 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."[23] Any liability that meets this three-pronged test is taken into account through a deduction or capitalization in the year all tests are met.[24] The mere accrual and recording of a liability on the books, such as a warranty reserve or deferred revenue, does not give rise to a tax deduction, however. Even if the amount of such liability can be determined with reasonable certainty, economic performance must have occurred, which requires the performance of services, delivery of goods, use of property, or making certain payments.[25]

A deferred revenue liability is an obligation to deliver goods or services. The existence of this liability is established when the taxpayer accepts an advance payment and, in return, agrees to the related contractual obligation. Arguably, the amount of this liability can be determined with reasonable accuracy, by reference to the amount of cash received, the costs involved in the performance of the obligation, or the amount that an unrelated third person would require to assume that liability.[26] This leaves the third condition of economic performance absent, because the taxpayer has not incurred the costs associated with the delivery of the goods or services with respect to which the advance payments were received.[27] The lack of economic performance prevents an immediate deduction for the deferred revenue liability.

In an asset acquisition, the buyer's aggregate tax basis in the acquired assets includes the amount of the seller's liabilities assumed in the transaction.[28] However, where a liability has not been taken into account under general tax principles, the total basis of the acquired assets does not include the amount of that liability until and unless that liability is taken into account in a subsequent period.[29] For assumed liabilities for which economic performance has not occurred at the time of acquisition, the buyer obtains additional basis in the acquired assets when economic

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in methodology, the amount allocated to each asset may not always be the same for GAAP and tax purposes.

[22] Rev. Rul. 76-520, 1976-2 C.B. 42; James M. Pierce Corp. v. Comm'r, 326 F.2d 67, 70 (8th Cir. 1964).

[23] Treas. Reg. § 1.446-1(c)(ii) (emphasis added).

[24] *Id.*

[25] I.R.C. § 461(h)(2).

[26] This premise may be open for debate. As discussed *infra* Part II.A.ii, determination of the amount of the liability is not clear.

[27] Treas. Reg. § 1.461-4(d)(4).

[28] I.R.C. §§ 338(b)(5), 1060(a); Treas. Reg. § 1.338-5(b)(1)(iii).

[29] Treas. Reg. § 1.338-5(b)(2)(ii).

performance has occurred.[30] Thus, the buyer would obtain no additional basis in the acquired assets as goodwill until the buyer has performed the services or delivered the goods for which the advance payments were made. Hence, contrary to GAAP, the basis increase is delayed until economic performance has occurred.

This timing issue carries tax consequences. While GAAP does not provide for amortization of goodwill, acquired goodwill is amortizable for tax purposes over a 15-year period under § 197. Therefore, a delay in recognition of the basis for goodwill would result in a deferral of the associated amortization deduction. Although § 197(a) provides that the amortization of acquired intangibles begins with the month in which such intangibles are acquired, this additional basis is amortized over the remaining recovery period beginning when it is properly included in the basis of the asset.[31] If this inclusion occurs after the asset's recovery life has expired, the taxpayer is entitled to an ordinary deduction for that additional amount in the year of inclusion.

ii. Amount of Deferred Revenue Liability

The correct amount of a deferred revenue liability is not certain. GAAP recognizes the acquisition date fair value of the liability as the amount assumed by the buyer.[32] In the example, the amount of the liability for GAAP purposes would most likely be $150,000, which is the amount the parties agreed upon in determining the cash consideration for the encumbered assets. For tax purposes, the amount of a liability is normally measured by the cost of the required economic performance.[33] In the example, Bob will incur no actual costs in performing the contractual obligations he assumed. Whether Bob has assumed a liability with no value in the transaction or a liability with a value equal to the economic burden associated with the obligation to perform the audit is an issue that has not been addressed in the existing authority.

The amount of the liability assumed has a tax consequence, because that amount is included in his basis in the acquired assets. If, based on the amount of costs Bob will incur, the amount of liability assumed by Bob is zero, his basis in the acquired assets is $950,000.[34] If instead the amount of the liability is determined based on economic burden, his basis in those assets will be greater. Considering that the value of the acquired assets is $1.1 million, the value of the liability assumed by Bob should be more than zero.

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[30] *See* Treas. Reg. § 1.338-5(b)(2)(iii) Ex. 2.

[31] Treas. Reg. § 1.197-2(f)(2). *See also* Albany Car Wheel Co. v. Comm'r, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); Meredith Corp. v. Comm'r, 102 T.C. 406 (1994).

[32] FASB ASC 805-20-30-1.

[33] Treas. Reg. §§ 1.461-4(d)(4)(i), 1.461-4(d)(7) Ex. 1, 1.461-4(d)(7) Ex. 2.

[34] Under the residual method, Bob's total consideration amount of $950,000 would be allocated $100,000 to cash and $850,000 to goodwill, which is amortizable over 180 months under § 197.

Regulations address the out-of-pocket costs incurred by the taxpayer who originally incurred the liability as the cost of economic performance.[35] For that taxpayer, the use of out-of-pocket costs is appropriate, because the issue is the amount to be deducted for the liability. Including the opportunity costs of the additional income that the taxpayer will forgo by performing the required contractual tasks would not be appropriate, because the taxpayer will not include that lost income in its taxable income. By contrast, in a situation where the taxpayer assumes a liability as part of an asset acquisition of a business, valuation of the cost (or burden) associated with that liability should include not only the out-of-pocket costs of performance but also the opportunity costs of the income the acquirer must forgo from other work. In other words, the amount of the liability should be the amount by which the parties agree to reduce the total consideration, which generally would include the buyer's opportunity costs. This issue is not addressed in the regulations.

Judicial precedent hints at the possibility that where a buyer in an asset acquisition assumes an obligation to perform contractual obligations for less than a normal profit, the shortfall is treated as an assumed liability. However, this dictum is not clear enough to firmly establish this principle. In *Commissioner v. Oxford Paper*,[36] the taxpayer acquired several assets (including cash) in exchange for the assumption of a lease in perpetuity. To the extent the present value of total payments due under the lease exceeded the cash the taxpayer received, the court viewed the taxpayer as having assumed a burden (a liability) in exchange for the other assets. Accordingly, the court assigned a depreciable basis to the acquired assets equal to the amount of such excess. The amount of the liability related to the lease was determined by reference to the amount of the required lease payments, and the question of opportunity cost did not arise.

Similarly, in a private letter ruling, the IRS acknowledged that the cost of terminating a contractual agreement assumed as part of an asset acquisition must be capitalized to the acquired assets.[37] In the ruling, the seller of a business transferred several contracts to the buyer as part of the sale. Each contract was valued as either a benefit (for which one would pay to assume) or a burden (for which one would pay another to assume). After the acquisition, the buyer paid a fee to terminate one of the unfavorable contracts acquired, and the IRS ruled that the fee was a deductible expense, because the contract became disadvantageous in the buyer's hands after the assets had been acquired. Thus, the IRS implicitly acknowledged that the fee would have been capitalized had the contract been disadvantageous (a burden) at the time of the acquisition.

In both *Oxford* and the ruling, the amount of the liability resulting from an unfavorable contract was determined by reference to the buyer's out-of-pocket costs. Neither discussed the effect of the forgone profits (that is, the buyer's

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[35] *Id.* Treas. Reg. §§ 1.461-4(d)(4)(i), 1.461-4(d)(7) Ex. 1, 1.461-4(d)(7) Ex. 2**.**
[36] 194 F.2d 190 (2d Cir. 1952).
[37] Priv. Ltr. Rul. 200730014.

opportunity cost of performing the obligations) under an assumed contract. An argument can be made that the buyer should also obtain basis in additional goodwill for the economic cost of the forgone profits in assuming the obligation. In the example, going strictly by costs of performance, Bob would get no additional basis in goodwill, since he would perform all the required services himself at no cost. Yet, the opportunity cost of performing those services would be $150,000 (the income he would forgo from performing services for paying clients). The most economically sound position would be that Bob should get an additional $150,000 basis in the acquired goodwill, because the total basis in the assets would equal their fair market value at acquisition of $1.1 million (considering the bases of both cash and goodwill).[38]

Revenue Ruling 76-520[39] provides the IRS's most direct analysis as to the treatment of future performance obligations assumed in an acquisition of assets. In the ruling, assets and liabilities of a publishing business were transferred through a nontaxable liquidation of a subsidiary. Under the tax law in effect at the time, the bases of the assets to the distributee were determined by reference to the basis of the stock of the liquidated subsidiary, plus the liabilities assumed by the distributee in the liquidation. The ruling held that the distributee was required to capitalize costs incurred in servicing the deferred revenue contracts acquired from the seller, because liabilities were assumed as part of the distribution. Under the logic of this ruling, such costs would also be required to be capitalized by the buyer in a taxable asset acquisition of a business, since assumed liabilities generally increase the basis of the acquired assets. The liabilities would be included in the buyer's bases as additional goodwill when economic performance occurs, with the cost recovered through amortization.[40] The ruling also determined the cost of performance to be the cost of satisfying an obligation assumed from the other party.

The treatment prescribed by Revenue Ruling 76-520 denies a deduction for any costs of performance on obligations assumed with respect to the deferred revenue obligations in the year incurred. Instead, under the ruling, those performance costs are added to the basis of the acquired assets and recovered over the remaining depreciable lives of those assets. The amount of additional basis is determined with respect to the amount of the cost incurred for such performance, without any consideration of a reasonably expected profit.

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[38] This would be consistent with the GAAP treatment. GAAP would assign a "fair value" to the unearned revenue liability equal to $150,000—the amount an unrelated party would require to assume that obligation. Thus, Bob would get the full book value of $1.1 million in the acquired assets, including $1 million assigned to goodwill. In exchange, GAAP would require Bob to recognize $150,000 of income as he performed the services required under that obligation. *See* FASB ASC 606-10-25-1 and transitional guidance in FASB ASC 606-10-65-1.

[39] 1976-2 C.B. 42.

[40] *See, e.g.*, Illinois Toolworks, Inc. v. Comm'r, 355 F.3d 997 (7th Cir. 2004); Pacific Transp. Co. v. Comm'r, 483 F.2d 209 (9th Cir. 1973); Haden v. Comm'r, 165 F2d 588 (5th Cir. 1948).

iii. Income Recognition

An additional issue is whether the buyer should recognize income from its performance under the deferred revenue obligation. A further question is whether such income would be recognized immediately upon consummating the acquisition transaction or upon performance of service or delivery of goods. GAAP requires income recognition upon performance.[41] In the example, should Bob recognize $150,000 as income (the deferred revenue amount), and does the answer depend on whether Sue already recognized the income?

The IRS addressed the question as to income inclusion in Revenue Ruling 71-450.[42] In the ruling, *S*, the owner of a newspaper business, sold all assets of the business and transferred all its liabilities to *P*, the purchaser. *S* had received cash for prepaid subscriptions before the sale. The parties effected the transaction in two parts under separate agreements. In the first part, *P* paid cash for all the assets and assumed all the liabilities except for the unearned revenue for the prepaid subscriptions. In the other, *S* paid cash to *P*, equal to the amount of the prepaid subscriptions. The IRS held that the payment made by *S* to *P* for assuming the unearned revenue liability was gross income to *P*.[43] The amount of cash paid by *P* to *S* was the net of the gross amount paid for the assets and the amount *S* received for assuming the deferred revenue liability.

To draw a parallel to the hypothetical, Sue and Bob could have documented the sale as two separate transactions: one in which Bob paid Sue $1.1 million for the assets of her practice (cash and goodwill), and another wherein Sue paid Bob $150,000 for performing the audit she was contractually obligated to perform. Changing the mechanics of the transaction in this manner would not change its substance. The result would be a net cash payment of $950,000 by Bob to Sue for all assets and liabilities of her practice. Therefore, Sue and Bob should be able to apply this methodology to their transaction without changing its form.

Revenue Ruling 71-450 does not address the question of when the revenue is included in the buyer's income. A payment made by the seller to the buyer would be an advance payment includible in his gross income under relevant tax principles.[44]

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[41] FASB ASC 606-10-25.

[42] 1971-2 C.B. 78.

[43] Although not discussed in the ruling, the buyer could defer the income recognition if it uses the accrual method. In the case of prepaid subscription revenues, § 455 allows an election for indefinite deferral of income during the period of time the taxpayer has a performance obligation. The facts and rulings of Revenue Ruling 71-450 can be extended to a similar transaction related to advance payments received for delivery of goods or performance of services, where an election to defer income recognition can be made under § 451(c). The fact that the deferral in the latter case would not be indefinite should not affect the application of the basic premise of the ruling.

[44] In the ruling, the advance payments would be subject to deferral under § 455. In the example, Bob would be considered to have received an advance payment, the amount of which he could elect to defer under § 451(c).

iv. Inconsistent Approaches

The approaches prescribed by the IRS for determination of the amount of the liability to be included in the buyer's total basis of the acquired assets in Revenue Ruling 76-520, on the one hand, and for inclusion of the advance payment in the income of the buyer in Revenue Ruling 71-450, on the other hand, create an interesting conflict. In requiring the buyer to include the cost of performance in the basis of the assets, Revenue Ruling 76-520 disallows a current deduction of those costs by the buyer. Yet, Revenue Ruling 71-450 requires the buyer to include the amount of the advance payments in his gross income. The two requirements result in the buyer recognizing income for performing contractual obligations but being barred from currently offsetting the cost of such performance against the income recognized.[45]

This inconsistency results from combining two sources of authority issued from different perspectives that were not intended to be superimposed. Revenue Ruling 71-450 treats the buyer as if he received the advance payments in a transaction separate from the acquisition of the assets. As such, the buyer should be entitled to a deduction for the costs related to the income recognition as he would if the separate transaction were the only one he was engaged in. But the buyer in Revenue Ruling 76-520 is presumed to have acquired the assets subject to the deferred revenue liabilities, all as part of the same transaction. Those are two mutually exclusive presumptions and cannot be made simultaneously regarding the same transaction. Instead, one approach or the other should be adopted by the buyer. As both rulings are still in effect and the IRS has published no clarifying guidance, a buyer would appear to have a choice as to which approach to use.

Revenue Ruling 76-520 does not consider a reasonable profit margin, which can result in taxpayers having different tax consequences from substantially the same transaction, depending on how their post-transaction operations are structured. In the example, Bob would get an initial basis of $950,000 in the acquired assets equal to the cash he paid Sue. He would not be allowed to deduct the costs of performing his contractual obligation on the acquired audit engagement but would add those costs to basis for the acquired assets (in this case, additional goodwill). Since Bob plans to do all the work himself, he would have no out-of-pocket costs. Therefore, Bob's total basis in the assets would remain $950,000—$100,000 cash and $850,000 amortizable goodwill. Another taxpayer in Bob's situation might instead contract with another firm to perform this audit for the $150,000 going price for such services. Doing so would free up that taxpayer's time

[45] Revenue Ruling 71-450 is silent as to the timing of inclusion in the buyer's income. The inclusion is subject to the buyer's method of accounting and its election, if any, to defer the income. In the transaction described in the ruling, § 455 would allow for deferring the income from prepaid subscriptions and recognizing the income as subscription obligations were performed. Therefore, a buyer receiving advance payments for delivery of goods or performance of services is allowed to defer income recognition as permitted under § 451.

to perform equivalent services to his clients and earn $150,000. That taxpayer would economically be in the same position as Bob, since he earned the $150,000 profit that Bob chose to forgo but ended up paying that amount to another firm. Yet, that taxpayer would be in a different tax position, as the $150,000 paid to the subcontractor would be added to the basis of its acquired goodwill. Thus, he would have goodwill of $1 million to amortize, whereas Bob would have only $850,000 of goodwill, even though Bob and the other taxpayer are in the same economic position. They have both performed the same work, with the same value, and they are out of pocket the same net amount of cash from the transaction. Certainly, the other taxpayer's tax consequences would more accurately reflect his economic reality than do Bob's tax consequences, as the taxpayer's goodwill would be $1 million, which is its fair market value. This inconsistency is created by the failure of Revenue Ruling 76-520 to consider a reasonable profit margin as an opportunity cost of performance and its requirement to capitalize only out-of-pocket costs of the buyer post-acquisition.

B. *Seller's Issues*

The seller in an asset sale with deferred revenue liabilities also faces tax issues. The first issue is whether the seller recognizes income from advance payments on which no income has been recognized at the time of the sale. There is no controversy regarding this question: the seller must recognize any deferred income at the time of the sale. Regulations generally require income inclusion when the taxpayer ceases to exist, or its obligation for the advance payments is satisfied or otherwise ends because of a taxable transaction.[46] In the example, Sue recognizes $100,000 of income at the time of the sale. A second issue is whether the seller increases its amount realized by the amount of the deferred revenue obligation. A third issue is whether the seller can take a deduction for the deferred revenue liability upon completing the transaction. These issues are controversial.

In a landmark case, *James M. Pierce Corporation v. Commissioner*, the Eighth Circuit Court of Appeals ruled that the seller is entitled to a deduction for a deemed payment of the liability associated with an advance payment.[47] In the court's view, the assumption by the buyer of the seller's performance obligation is akin to the constructive receipt of cash by the seller, followed by a separate payment by the seller to the buyer equal to the deferred revenue:

> By [the buyer's] assumption of the obligations which those reserves represented, the taxpayer's cash received on the sale of the business was reduced. This is just as much an out-of-pocket payment by the taxpayer as if it had first received the gross amount from Prairie and then repaid Prairie cash equal to the amount of the reserves. It is just as much an out-of-pocket payment by the taxpayer as if, in fiscal 1957, it had used other available cash of its own and

[46] Treas. Reg. § 1.451-8(c)(4).
[47] James M. Pierce Corp. v. Comm'r, 326 F.2d 67 (8th Cir. 1964).

> on its own initiative refunded the subscribers the amounts of their unearned or redeemable subscriptions.[48]

The IRS has ruled consistently with *Pierce*. In Revenue Ruling 68-112,[49] the buyer and seller made an arrangement separate from a business asset sale, wherein the seller paid the buyer cash to assume the seller's liability for prepaid newspaper subscriptions. The seller had deferred income recognition under § 455. The IRS ruled that the seller was entitled to a deduction for this payment under § 162, reasoning that the taxpayer would have been entitled to a deduction had it paid an equivalent amount directly to the subscribers to extinguish the liability.

The *Pierce* opinion did not directly address whether the amount of the liability would be included in the seller's amount realized. Under the law in effect at the time, the sale of the business assets as part of the plan of a complete liquidation was a nontaxable event.[50] As such, the inclusion of the liabilities in the amount realized would have had no tax consequences. However, the court considered the assumption of the obligation by the buyer as equivalent to a payment of cash to the seller, and the payment of that cash by the seller to satisfy the obligation.[51] The deemed receipt of cash by the seller would be an additional amount realized on the sale and would have been included in the computation of gain or loss had the sale of assets been taxable. This implicit conclusion in a taxable transaction is founded on general regulatory authority. In any sale or disposition of property, the amount realized includes any liability that the transferor is relieved of.[52] More specifically, in a taxable sale of business assets, the regulations include liabilities assumed by the buyer in the computation of the amount realized by the seller, with no exception for a deferred revenue liability.[53]

The inclusion in the amount realized is not a substitute for recognition of deferred income from the advance payment. The two occur concurrently, under the different sources of authority.[54] The amount of income the seller recognizes from the advance payment is easily determinable. This amount is equal to the advance payment received by the seller.[55] In determining the amount of the deferred revenue liability to include in the amount realized, however, the seller will encounter the same uncertainty as to the amount of liability as the buyer does.[56] It is precisely the inclusion of the amount of the liability in the amount realized that gives rise to a

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[48] *Id.* at 72.
[49] 1968-1 C.B. 62.
[50] I.R.C § 337 (as in effect at the time of the transaction at issue).
[51] 326 F.2d 67, 72 (8th Cir. 1964).
[52] Treas. Reg. § 1.1001-2(a).
[53] I.R.C. §§ 338(b)(5), 1060(a)(2); Treas. Reg. § 1.338-4(b)(1)(ii).
[54] Field Service Advice 200048002 encapsulates the concept of dual inclusion. In a sale of assets, the seller includes both the amount of the advance payments in its gross income and the relief of the liability in its amount realized.
[55] I.R.C. § 451(c).
[56] *See supra* Part II.A.ii.

deduction to the seller.[57] Thus, the deduction amount is generally equal to the amount included in the seller's amount realized, which often produces additional gain.[58] Thus, through the buyer's assumption of the liability related to the advance payments (and, in fact, for all liabilities for which a deduction has not yet been claimed), the seller receives a deduction against ordinary income and recognizes gain in the same amount. Since ordinary income and capital gains are taxed differently, the amount assigned to the liability is important.

In the example, it is not clear under existing authorities whether the correct amount for Sue to include in her amount realized for the deferred revenue liability is the $100,000 received as an advance payment, the amount received plus the opportunity cost of performing the services, or some other amount. Whatever the correct amount of inclusion in her amount realized is, she would be entitled to the same amount as an ordinary deduction.[59]

III. TWO APPROACHES

The primary authorities related to the transfer of deferred revenue liabilities from advance payments in asset sale transactions discussed in Part II have been adopted in practice through two different approaches: "the separate transaction approach" and the "assumed liability approach." Originally proposed by the American Institute of Certified Public Accountants (AICPA) ,[60] these approaches are now widely accepted in tax practice. Because of the absence of a comprehensive set of rules, the approaches rely on authorities that can produce substantially different tax consequences for the same transaction. Neither approach is required or formally blessed by the IRS or the Treasury, and one approach can be used by the buyer and the other by the seller for the same transaction.

A. *The Separate Transaction Approach*

As the name implies, the separate transaction approach views the asset sale and the assumption of the deferred revenue liability by the buyer as two separate taxable transactions. In one transaction, the seller transfers all its assets and liabilities (except for the deferred revenue liability) to the buyer for consideration equal to their net fair market values. In a separate transaction, the seller pays some of the consideration received in the first transaction to the buyer in exchange for

[57] *See* Treas. Reg. § 1.461-4(d)(5) (incorporating the judicial precedent established by *Pierce*, often referred to as the "economic performance" regulation).
[58] To the extent this additional amount realized is allocated to goodwill, it produces a capital gain. Self-created goodwill is not excluded from the definition of a capital asset under § 1221 and has zero basis.
[59] Treas. Reg. § 1.461-4(d)(5).
[60] *See* Letter from AICPA to Andrew Keyso, Jr., IRS Chief Counsel, Income Tax & Accounting (IT&A) (Apr. 23, 2015), https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Deferred-Revenue-Comment-Letter-Final.pdf.

the buyer's assumption of the deferred revenue liability.[61] The seller's amount realized includes the amount of the deferred revenue liability (in addition to cash and other consideration received), and the seller pays or is deemed to pay that amount to the buyer, resulting in a net receipt of cash equal to the actual cash consideration amount. Accordingly, the seller's gain on the sale is increased by the amount of the deferred revenue liability, and the seller claims an ordinary deduction for the same amount.[62] The seller also recognizes income for any portion of the advance that was not previously included in gross income.[63]

The buyer receives or is deemed to receive the same amount as the advance payment for accepting the performance obligation and recognizes gross income or defers income recognition, as appropriate, under its method of accounting.[64] Although economic performance on liabilities assumed in an asset acquisition increases the basis of the acquired assets,[65] the costs of performance under a deferred revenue obligation are not capitalized, because the obligation associated with the deferred revenue liability is not treated as assumed in the asset acquisition. Instead, the obligation is assumed in a separate transaction in exchange for receiving a cash payment, and the buyer deducts the costs of performance.

For example, assume that assets with a fair market value of $100 and an unearned revenue liability of $30 for services to be performed were transferred to the buyer for $70. Under the separate transaction approach, the buyer is deemed to have paid $100 for the assets and to have received $30 in cash to assume the unearned revenue liability. This deemed payment of $30 is treated as an advance payment to the buyer, and the buyer recognizes income from this payment unless it properly elects to defer this recognition under § 451(c). As such, the buyer has a basis of $100 in the assets, thus precluding the need to increase the basis for any costs incurred in performing the required services. The costs of performance are related to a separate transaction and should be deducted against the $30 of income recognized from the advance payment received from the seller.

The seller would have an amount realized of $100 on the sale of assets, reflecting the actual or deemed receipt of the $100 cash payment. The seller could deduct $30 against ordinary income for the payment or deemed payment to the buyer to assume the deferred revenue liability. In addition, the seller would recognize gross income for any amount of the advance payment it originally

[61] In some transactions, this exchange may in fact occur as a separate arrangement, either according to the asset purchase agreement or under a separately executed contract. The latter scenario would replicate the fact pattern presented in Revenue Ruling 68-112 and Revenue Ruling 71-450, discussed *supra* text accompanying notes 49 and 42, respectively.

[62] Rev. Rul. 68-112, 1968-1 C.B. 62.

[63] Treas. Reg. § 1.451-8(c)(2).

[64] I.R.C. § 451(c); Treas. Reg. § 1.451-8.

[65] Illinois Toolworks, Inc. v. Comm'r, 355 F.3d 997 (7th Cir. 2004); Pacific Transp. Co. v. Comm'r, 483 F.2d 209 (9th Cir. 1973); Haden v. Comm'r, 165 F2d 588 (5th Cir. 1948).

received that gave rise to the deferred revenue liability of $30, to the extent such amount had not already been included in its gross income.

The separate transaction approach does not resolve the controversy regarding the amount of the deferred revenue liability, which would be the amount deemed to have been exchanged between the parties for its assumption. The example assumed that amount was $30, although no information was provided as to whether that amount equaled the amount of the original advance payment, the costs the buyer would incur for the performance of the related obligation, or the amount a reasonable buyer would be paid to assume those obligations including a reasonable profit margin.

Applying the separate transaction approach to the hypothetical, Sue would have a total amount realized of $1.1 million, comprised of the $950,000 cash payment she received, plus the $150,000 she is deemed to have paid back to Bob to assume the deferred revenue liability. Because of that deemed payment, Sue would also have an ordinary deduction of $150,000. In addition, Sue would be required to include the $100,000 advance payment in her gross income under Regulation § 1.451-8(c)(4). Bob would have total basis of $1.1 million in the acquired asset, equal to the amount he is deemed to have paid Sue. He would also be deemed to have received an advance payment of $150,000, representing the deemed payment from Sue to assume the performance obligation for the audit engagement, which he would recognize as income as required by § 451(c). If he were to incur costs in such performance, he would be entitled to a deduction for those costs to offset the $150,000 income recognized. Under the assumptions of this example, he would incur no cost in performing the required services, and therefore no deduction would arise.

B. *The Assumed Liabilities Approach*

Under the assumed liabilities approach, the parties would treat the deferred revenue as a liability the buyer assumed from the seller as part of a single asset purchase transaction. The seller would increase its amount realized by the amount of the deferred revenue liability[66] and would take an ordinary deduction in the same amount.[67] After including the deferred revenue liability in its amount realized, the seller would have the same amount realized as it would under the separate transaction approach. Although the mechanics of the computations differ, the amount deemed received and paid back to the buyer under the separate transaction approach and the amount of the deferred revenue liability included in the amount realized under the assumed liabilities approach should be the same. The amount of the deduction for the deemed payment of the deferred revenue liability also would be the same under both approaches. The assumed liability approach thus also leaves unresolved the controversy as to the amount of the deferred revenue liability for the seller. Just as under the separate transaction approach, the seller would recognize

[66] I.R.C. §§ 338(b)(5), 1060(a); Treas. Reg. § 1.338-4(b)(1)(ii). *See* also Treas. Reg. § 1.1001-2; Crane v. Comm'r, 331 U.S. 1 (1947); Tufts v. Comm'r, 461 U.S. 300 (1983).
[67] James M. Pierce Corp. v. Comm'r, 326 F.2d 67 (8th Cir. 1964); Treas. Reg. § 1.461-4(d)(5).

any amount of the advance payment previously deferred as income upon completion of the transaction.[68]

The buyer's tax consequences, however, would differ from the separate transaction approach. The buyer's basis in the acquired assets would include all liabilities assumed in the transaction,[69] including the liability associated with the advance payments. The amount of the deferred revenue liability would be the cost of performing the services (or the cost of delivering the goods) as required under the assumed obligation.[70] The buyer would not be allowed a deduction for performance costs[71] but instead would obtain basis in the acquired assets when the costs are incurred and would recover the basis through amortization.[72]

In the example, under the assumed liabilities approach, Sue's treatment would theoretically remain the same as in the separate transaction approach. Her amount realized would include the cash consideration of $950,000 received and the amount of the deferred revenue liability assumed by Bob. Based on the known facts, one could logically conclude that the amount of the liability assumed by Bob is $150,000, the amount he would have to pay another party to assume the obligation related to that liability. Sue would also be required to include the $100,000 advance payment in her gross income.[73] Therefore, Sue's tax consequences should not be different under either approach.[74]

Bob's tax consequences, however, could be significantly different under the assumed liabilities approach. Bob's aggregate basis in the assets upon acquisition would be $950,000, the amount of the cash payment. The deferred revenue liability is not added to Bob's basis until economic performance is satisfied.[75] With respect to the obligation to perform the required audit, economic performance occurs as Bob incurs costs in connection with such obligation.[76] If, following the assumptions of the example, he performs all the work himself, he obtains no additional basis in the acquired assets. Should he decide to assign the work to employees or another

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[68] Treas. Reg. § 1.451-8(c)(4).
[69] I.R.C. § 1060(a); Treas. Reg. § 1.338-5(a)(1)(iii).
[70] Rev. Rul. 76-520, 1976-2 C.B. 42.
[71] *See, e.g.*, Illinois Toolworks, Inc. v. Comm'r, 355 F.3d 997 (7th Cir. 2004); Pacific Transp. Co. v. Comm'r 483 F.2d 209 (9th Cir. 1973); Haden v. Comm'r, 165 F2d 588 (5th Cir. 1948).
[72] Treas. Reg. § 1.197-2(f)(2); Minneapolis & St. Louis Ry., 260 F.2d 663 (8th Cir. 1958); Albany Car Wheel Co. v. Comm'r, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2nd Cir. 1964); Meredith Corp. v. Comm'r, 102 T.C. 406 (1994).
[73] Treas. Reg. § 1.451-8(c)(4).
[74] The approaches are both predicated on determination of the amount of the deferred revenue liability. In the current example, because of the trail of events that allowed the determination, the amount of the liability could reasonably be estimated to be $150,000. In practice, without such a clear factual trail, determination of the amount of the liability might not be so simple. As a result, the amount of the advance payment itself ($100,000 in the example) is often used as a proxy for the amount of the deferred revenue liabilities.
[75] Treas. Reg. § 1.338-5(b)(2).
[76] Treas. Reg. § 1.461-4(d)(4).

firm, he would obtain additional basis in the assets for any amounts paid for those services but would not be entitled to a deduction for such payments.[77]

IV. NEED FOR GUIDANCE AND PROPOSED SOLUTIONS

The IRS has acknowledged the need for comprehensive guidance in this area. "Guidance under § 451 regarding the treatment of advance payments" first appeared in the IRS Chief Counsel's Priority Guidance Plan in 2001[78] and continued to be included until 2015.[79] It is not known if the Treasury and the IRS intend to provide additional guidance and, if they do, how much of a priority it would be.

While it is easy to surmise why the IRS once made it a priority to provide guidance on an area riddled with ambiguity, it is hard to fathom why the IRS abruptly abandoned it as a priority. The issue is no less complex today than it was in 2015, and the Tax Cuts and Jobs Act of 2017[80] did not reduce the complexity. Additional, more cohesive guidance is still needed. Until the Treasury and the IRS again acknowledge the need for guidance, and until the priority moves from plan to action, buyers and sellers of businesses with deferred revenues will face unresolved issues and inconsistencies.

The tax controversies discussed in this article could be resolved if the regulatory guidance abandoned the disjointed sources of authority and instead borrowed methodologies from GAAP. Under GAAP, a deferred revenue obligation is a liability,[81] and assets and liabilities must be recorded on the books of the acquiring entity at their fair values in a business combination.[82] Consequently, GAAP requires a valuation of the amount of the liability for the deferred revenue obligation, which may be the amount of cash received by the seller, the amount agreed to by the parties, or another amount. For example, in our hypothetical scenario, Sue received an amount for the deferred revenue obligation that was less than the value of the liability she assumed. The value may be determined by the buyer in the post-acquisition measurement period to be a different amount, in which case a post-transaction adjustment would be required on the books of the acquirer.[83]

Adopting this approach, regulations could require a value be assigned to the deferred revenue liability under normal valuation standards of "willing buyer/willing seller." Under this standard, the value of the liability would be what a willing assignee would require as payment to assume the obligation to perform

[77] Illinois Toolworks, Inc. v. Comm'r, 355 F.3d 997 (7th Cir. 2004); Pacific Transp. Co. v. Comm'r 483 F.2d 209 (9th Cir. 1973); Haden v. Comm'r, 165 F.2d 588 (5th Cir. 1948).
[78] *See* https://www.irs.gov/pub/irs-utl/2001_pgp.pdf (Income Tax Accounting, Item 12).
[79] *See* https://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf (Income Tax Accounting, Item 10).
[80] Pub. L. No. 115-97, 131 Stat. 2054 (2017).
[81] FASB ASC 430-10.
[82] FASB ASC 805-20-30-1.
[83] FASB ASC 805-20-35.

the contractually required tasks, with reasonable ranges established based on industry data and statistics. Once the value of the deferred revenue liability is determined, the tax consequences would be easier to determine. The seller would recognize any income not previously recognized from the receipt of the advance payment (i.e., the original amount received).[84] The seller would then include the amount of the liability in its amount realized and would take an ordinary deduction in the same amount.

Under new regulations, the buyer would recognize income from the deemed receipt of an advance payment under a separate transaction approach, which would equal the amount of the liability. The timing of income recognition would be determined under § 451(c), and the basis of the acquired assets would be increased by that same amount. The buyer would be deemed to have paid cash for the assets, which included the value of the deferred revenues and to have received that amount as an advance payment for performing the services. The amount of the liability would be included in the basis of the acquired assets. Thus, there would be no need to capitalize costs of performance, and those costs could be deducted against the income included from the advance payments. The regulations could specify when the deemed payment would be included by the buyer in the basis of the acquired assets. A consistent and equitable time for such inclusion would be at the point the income from the advance payments is recognized.

Issuing tax guidance consistent with GAAP principles may not be a desirable alternative for tax practitioners. There are valid reasons for differences between GAAP and tax rules for income recognition, and adopting GAAP principles in tax guidance may raise concerns for some tax practitioners. A more practical alternative for guidance on the transfer of deferred revenue liabilities would be to use the "constructive completion" method currently prescribed in the regulations for long-term contracts related to the taxable sale of assets.[85] Under this method, the seller is treated as completing the contract in progress on the day of the transaction, and the buyer is treated as entering into a new contract on the same day.[86] Each party recognizes total income under the contract based on actual cash payments already received from the customer (for the seller) and to be received (for the buyer), both adjusted for a deemed consideration amount.[87] The consideration amount is the amount the seller is deemed to have paid the buyer, or that the buyer is deemed to have paid the seller, as the case may be, for the seller to assume the

[84] Treas. Reg. § 1.451-8(c). This rule would remain in effect under any new guidance, because the new guidance would affect the treatment of the deferred revenue liabilities by the seller and the buyer and not the acceleration of deferred income from advance payments.

[85] Treas. Reg. § 1.460-4(k)(2). The other method, the "step-in-the-shoes" method, described in Regulation § 1.460-4(k)(3), pertains mostly to tax-free transfers. Transfers of deferred revenues in tax-free transactions and a full discussion of the intricacies of transfers of long-term contract rights and obligations are beyond the scope of this article.

[86] Treas. Reg. § 1.460-4(k)(2).

[87] *Id.* This formula simply computes the total amount of the income to be recognized (the "contract price"). The timing of the income recognition is determined under the percentage-of-completion method, as prescribed in § 460.

rights and the obligations under the contract. This amount is determined using the residual method under Regulation §§1.338-6 and 1.338-7—the same methodology required to determine the consideration amount allocable to the acquired assets. Thus, a contract, as a whole, is treated as either a benefit, for which someone would pay money, or a burden, which someone would pay to terminate.[88] In practical application, such determination could be made by discerning whether a hypothetical buyer would pay, or require payment, to accept the contract from a hypothetical seller, considering the total income yet to be collected from the customer on the contract, the total estimated costs of completing the contract, and a normal profit margin based on industry information and data.

This method could be adopted for all taxable asset acquisitions involving deferred revenues. Its application would differ in form from the first proposal described above, but its results would be substantially the same. In the example, the contract Sue signed with the client before the sale of her practice would be a burden of $150,000, based on what a hypothetical buyer would demand to assume the contract obligations and any expected additional future receipts under the contract (the latter is zero in our example). Sue would recognize income of the $100,000 already received from the customer, reduced by the $150,000 consideration she is deemed to have paid Bob, for a net loss of $50,000. She would include the $150,000 deemed paid to Bob in her amount realized on the sale of the assets, as that deemed payment is considered to have offset the amount that she would have received if not for the transfer of the deferred revenue liability. Thus, Sue would have an amount realized of $1.1 million, allocating $100,000 to the transferred cash and $1 million to the goodwill, consistent with their fair market values. Bob would increase the amount of income to be received under the contract (zero) by the deemed consideration of $150,000, and thus recognize a total income of $150,000 on the contract. His basis in the acquired assets would include Sue's deemed payment of $150,000, and $150,000 would be deemed to have been paid to Sue as additional consideration. Together with the actual cash payment of $950,000, his total basis in the assets would be $1.1 million (appropriately allocating $100,000 to cash and $1 million to goodwill).

New regulations could provide for consistency between the timing of the recognition of income by the buyer from the advance payments and the inclusion of the amount deemed paid in the basis of the acquired assets. This proposal also would effectively put the buyer and the seller on the separate transaction approach, with one significant difference: the amount deemed to have been separately exchanged by the parties would be determined by the value of the performance obligation, not by reference to the cash the buyer received as advance payment.

Under both of these proposed methods, it would be possible to deem a payment from the buyer to the seller for the assumption of the contractual rights and obligations, where the additional payments receivable under the contract

[88] The terms "benefit" and "burden" are not used in the regulations but are the author's choice of words for describing the methodology.

exceed the value of the performance obligation liability. In the hypothetical, assume that Sue accepted the audit engagement for a \$100,000 advance payment and an additional \$100,000 payment upon completion of the audit. Further, assume this audit would normally be performed for \$50,000. Sue would demand an additional \$50,000 from Bob for the sale of her practice, instead of \$50,000 less. Thus, she would transfer the goodwill worth \$1 million and \$100,000 cash to Bob for \$1.15 million. Both Sue and Bob would allocate \$1.1 million as consideration for the acquired assets, equal to their fair market value. The additional \$50,000 would be treated as a payment Bob made to Sue to assume this contract, under which he will receive \$100,000 for performing work worth only \$50,000. This additional deemed payment of \$50,000 would be accounted for by the parties in their recognition of income from the contract, separately from the sale of the assets. Instead of claiming the *Pierce* deduction, Sue would report additional ordinary income of \$50,000. The regulations under § 451(c) would need to be revised to include the \$50,000 as an advance payment received by Sue, in addition to the \$100,000 she received directly from the client. Alternatively, Sue could be required to recognize additional income from the contract, received in the sale of the assets, similar to what the provisions currently require for long-term contracts.[89] Bob would either be entitled to a deduction for his deemed payment of \$50,000 to Sue or would reduce the income recognized under the contract to \$50,000.[90]

These alternative proposals would provide uniformity in the tax treatment of the transfer of deferred revenue liabilities in acquisitive asset transactions. In particular, the second alternative, adopting rules from guidance on mid-contract changes of ownership in long-term contracts, is based on principles that have passed the test of time. Adoption of principles similar to those would provide the needed guidance to resolve many of the issues and related controversies discussed in this article.

CONCLUSION

The tax consequences to the buyer and seller in transferring deferred revenue liabilities as part of a taxable asset acquisition are determined from judicial precedent or revenue rulings that are not consistent. The only clear and consistent guidance is the acceleration of gross income of any amount of advance payments previously deferred by the taxpayer who first receives them upon transfer of the deferred liability. Regulations should comprehensively address the issues discussed in this article: the requirement for income recognition by a buyer assuming a deferred revenue liability associated with an advance payment, deductibility of costs in the discharge of those obligations, and the effect of the transfer on the gain or loss recognized by the seller and the basis of assets acquired by the buyer. If the IRS intends to provide more than one alternative to one or both parties, it should prescribe them in regulations instead of the current multiple authorities of revenue rulings issued at different times, in different contexts, and addressing only part of

[89] Treas. Reg. § 1.460-4(k)(2)(ii).
[90] Treas. Reg. § 1.460-4(k)(2)(iii).

the issues. Taxpayers should not have to speculate as to their choices for correct accounting for a transaction, as they do to a large extent under the two current approaches. The IRS should once again make the issuance of guidance in this area a priority. Guidance already exists in regulations related to long-term contracts that should be adopted for this purpose.