American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

April 23, 2015

Mr. Andrew Keyso, Jr.
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Recommendations on the Tax Treatment of Deferred Revenue in Taxable Asset Acquisitions

Dear Mr. Keyso:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to submit its recommendations on the tax treatment of deferred revenue in taxable asset acquisitions. These comments were developed by the Deferred Revenue Task Force of the AICPA Tax Methods and Periods Technical Resource Panel, and approved by the Tax Executive Committee.

The AICPA is the world's largest membership association representing the accounting profession, with more than 400,000 members in 128 countries and a history of serving the public interest since 1877. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

As discussed below, present law allows buyers and sellers discretion in choosing a tax method of accounting for deferred revenue liabilities in the context of a taxable asset acquisition. We understand that the government is considering issuing guidance that would provide for consistent tax treatment of the deferred revenue liability by buyers and sellers in taxable asset acquisitions. The AICPA believes that providing an elective tax safe harbor under which the buyer and seller agree to consistently treat the deferred revenue liability would reduce controversy between taxpayers and the Internal Revenue Service (IRS) and mitigate concerns the government might have related to inconsistent tax treatment by buyers and sellers in such transactions.

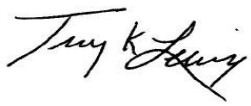
Accordingly, the AICPA has proposed a safe harbor under which the buyer and the seller would agree to the value of the deferred revenue liability for tax purposes and each party would account for such value according to general tax principles in the tax year of the sale. To the extent the actual liability differs from the agreed upon amount, such difference would be taken into account by the buyer as incurred (e.g., deducted or, if subject to section 263A, capitalized). The AICPA

believes this approach will provide clarity for taxpayers engaging in taxable asset transactions in addition to providing parity between the buyer and the seller.

* * * * *

We appreciate your consideration of our recommendations. We welcome a further discussion of these issues and our recommendations. If you have any questions, please contact Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-2290, or jrohrs@deloitte.com; Carol Conjura, Immediate Past Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 533-3040, or cconjura@kpmg.com; or Melanie Lauridsen, AICPA Senior Technical Manager, at (202) 434-9235, or mlauridsen@aicpa.org.

Sincerely,



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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Recommendations on the Tax Treatment of Deferred Revenue in Taxable Asset Acquisitions by Both the Buyer and the Seller

Developed by the AICPA Deferred Revenue in Taxable Asset Acquisitions Task Force

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April 23, 2015

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Recommendations on the Tax Treatment of Deferred Revenue in Taxable Asset Acquisitions by Both the Buyer and the Seller

I. Scope of Comments

Under present law, the tax accounting treatment of deferred revenue liabilities in the context of a taxable asset sale and acquisition is subjective. Relying on case law and IRS administrative guidance, taxpayers generally apply one of two different approaches, each of which is discussed in more detail below. As a result, each party to a transaction may choose to apply the same or a different method of tax accounting for the assumption of a deferred revenue liability. Additionally, within each method, for tax purposes, the timing of reporting the income and deductions may differ among taxpayers. As such, the AICPA believes the tax treatment of deferred revenue liabilities in taxable asset acquisitions warrants additional guidance.

This letter provides a summary of the present law and examples illustrating the application of each of the approaches under the present law. The letter also includes a safe harbor proposal, under which each party to the taxable asset acquisition would treat for tax purposes the value of the assumed deferred revenue liability as additional consideration paid or received, as applicable, allocable in accordance with section 1060[1] (the "Assumed Liability Safe Harbor"). Under this safe harbor, the seller would deduct and the buyer would capitalize the agreed upon value of the deferred revenue liability in the tax year in which the liability is assumed, and to the extent the buyer's actual liability exceeds the agreed upon amount, the buyer would take the excess into account as incurred (i.e., deducted or, if subject to section 263A, capitalized). If the two parties to the transaction agree in writing to the tax value of the assumed liability, the IRS should not challenge the use of the Assumed Liability Safe Harbor by the buyer and seller.

We believe the approach described above will provide taxpayers with much needed clarity on the tax accounting treatment of these transactions while also ensuring there is parity in tax treatment between the buyer and the seller.

A more detailed discussion of our recommendation is included below.

II. Background

Income Recognition – Generally

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is properly accounted for as of a different period.

Treasury Reg. § 1.451-1(a) provides, in relevant part, that under an accrual method of accounting, income is generally includible in gross income when all the events have occurred which fix the right to receive such income and the amount is determinable with reasonable accuracy. In general,

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended and the Treasury Regulations thereunder.

a taxpayer's right to receive income is fixed at the earlier of when (i) the required performance under the contract occurs, (ii) payment under the contract is due, or (iii) payment under the contract is received.[2] Thus, an advance payment generally must be recognized as income by an accrual method taxpayer in the year of receipt. However, the IRS has provided certain exceptions to the general rule of section 451(a) for certain advance payments described in Treas. Reg. § 1.451-5, Rev. Proc. 2004-34,[3] and sections 455 and 456.

Deferred Revenue Provisions

Treasury Reg. § 1.451-5

Treasury Reg. § 1.451-5(a)(1) defines an advance payment as an amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales pursuant to, and to be applied against, an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Treasury Reg. § 1.451-5(b)(1) generally provides that advance payments must be included in income either:

(i) In the taxable year of receipt, or

(ii) Except as provided in Treas. Reg. § 1.451-5(c),

a. In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or

b. If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

Treasury Reg. § 1.451-5(f) provides that if a taxpayer has adopted a method prescribed in Treas. Reg. § 1.451-5(b)(1)(ii), and "if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year."

Revenue Proc. 2004-34

Revenue Proc. 2004-34 allows taxpayers to defer tax recognition of advance payments arising from, among other things, the provision of services or the sale of goods (the "Deferral Method"). To qualify as an advance payment, section 4.01(2) of Rev. Proc. 2004-34 provides that the taxpayer must recognize the payment (in whole or part) in revenues in its applicable financial

[2] See Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 84-31, 1984-1 C.B. 127.
[3] 2004-1 C.B. 991.

statement[4] for a subsequent taxable year, or, for taxpayers without an applicable financial statement, the payment must be earned by the taxpayer (in whole or part) in a subsequent taxable year.

Under the Deferral Method described in Rev. Proc. 2004-34, a taxpayer with an applicable financial statement must include an advance payment in its gross income for the tax year of receipt to the extent the advance payment is recognized in revenues in its applicable financial statement for that tax year. Also, the taxpayer should include the remaining amount of the advance payment in gross income in the next succeeding tax year, unless it is a short tax year of 92 days or less. If a taxpayer does not have an applicable financial statement or is unable to determine the extent to which an advance payment is recognized in financial statement revenues in the year of receipt, the taxpayer must include in gross income in the year of receipt the amount of the advance payment that is earned in that year.

Section 5.02(5)(b) of Rev. Proc. 2004-34 provides that a taxpayer using the Deferral Method must include in gross income for the taxable year of receipt all advance payments not previously included in gross income if, and to the extent that, in that taxable year,

(i) The taxpayer's obligation with respect to the advance payment is satisfied or
(ii) Otherwise ends other than in a transaction to which section 381(a) applies or a section 351(a) transfer in which
    a. Substantially all assets of the trade or business (including advance payments) are transferred,
    b. The transferee adopts or uses the Deferral Method in the year of transfer, and
    c. The transferee and the transferor are members of a consolidated group.[5]

Section 455

Section 455 provides that a taxpayer may elect to include prepaid subscription income in gross income for the tax years during which a liability to furnish or deliver a periodical exists, rather than in the taxable year of receipt.

Section 455(b) designates two situations that will trigger the recognition of prepaid subscription income deferred by such an election. Under section 455(b)(1), if the liability ends, then so much of the prepaid subscription income that was not includible in gross income for preceding taxable years shall be included in gross income for the taxable year in which the liability ends. Section 455(b)(2) provides for a similar result if the taxpayer dies or ceases to exist.

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[4] An applicable financial statement is a financial statement that is (i) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders); (ii) a certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for credit purposes, reporting to shareholders, partners, or similar persons, or any other substantial non-tax purpose; or (iii) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

[5] For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77-37, 1977-2 C.B. 568, which provides that "[t]he "substantially all" requirement of sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) of the Code is satisfied if there is a transfer (and in the case of a surviving corporation under section 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer."

Section 456

Section 456 allows a taxpayer to recognize certain prepaid dues as income ratably over the period of time that such services are required to be rendered or that such membership privileges are required to be made available.

Similar to the other provisions described above, section 456(b)(2) provides that if the liability to provide services or membership privileges ends, then as much of such income as was not includible in gross income for preceding taxable years shall be included in gross income for the taxable year in which the liability ends. Further, if the taxpayer ceases to exist, then any prepaid dues not previously recognized as income must be included in gross income for the taxable year in which such cessation of existence occurs.

Deferred Revenue in Taxable Asset Acquisitions

Taxpayers, the courts, and the IRS have struggled with the appropriate tax treatment of a deferred revenue liability assumed in connection with a taxable asset acquisition. The result is often inconsistent tax treatment of a transaction by the buyer and the seller, and inconsistency in the timing of deduction and income recognition by buyers and sellers generally. For example, depending upon the characterization of the transaction, differences may occur with respect to the timing of recognizing income and deductions, if any, from the transaction and the proper amount of tax basis in the property transferred in the hands of the buyer. The two most common approaches used by buyers and sellers in tax accounting for deferred revenue liabilities assumed by the buyer in a taxable asset acquisition are discussed below.

Separate Transaction Approach

Overview

The first approach is to treat the assumption of a deferred revenue liability by one party (the buyer) in exchange for property from the other party (the seller) as a currently taxable transaction in which the buyer is paid by the seller to take responsibility for the deferred revenue liability (hereafter referred to as the "Separate Transaction Approach"). The buyer is deemed to receive a payment from the seller in exchange for agreeing to satisfy the deferred revenue liability, which is treated for tax purposes as income to the buyer and a cost for the seller.[6] The buyer is deemed to pay the payment back to the seller as an additional purchase price for the seller's assets. Thus, the buyer has full tax basis in the property transferred and will account for tax purposes for the costs to satisfy the assumed deferred revenue liability as they are incurred. If applicable, the buyer will depreciate the acquired assets.

The courts have addressed the Separate Transaction Approach from both the buyer's and the seller's perspective. For example, in *James M. Pierce Corporation v. Commissioner ("Pierce")*,[7] a corporation sold its assets to a second corporation in complete liquidation under section 337.

[6] Section 61(a) provides that "gross income" includes "all income from whatever source derived." In determining what sort of economic benefits qualify as income within the meaning of section 61(a), the Supreme Court has referred to "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431 (1955); *Commissioner v. Indianapolis Power & Light Co*., 493 U.S. 203, 209 (1990).

[7] 326 F.2d 67 (8th Cir. 1964).

The court concluded that the seller was entitled to a business deduction under section 162(a) in the amount by which the sales price of the assets was reduced in consideration of the buyer's agreement to perform under the contracts entered into by the seller and for which the seller had received advance payments that were required to be included in the seller's gross income. Although no separate payment was made by the seller, the court acknowledged that the cash the seller received for the sale of its assets was reduced by an amount equal to the amount of the assumed obligation. Thus, the seller was deemed to have made a payment to the buyer to satisfy the deferred revenue liability, which entitled the seller to a deduction under section 162.

Although *Pierce* addresses the deductibility of a deemed payment from the seller to the buyer to assume a deferred revenue liability that arose in connection with the seller's trade or business, the IRS reached the same conclusion when an actual payment was made from the seller to buyer. For example, in Rev. Rul. 68-112,[8] the IRS addressed the federal income tax consequences relating to the sale of a newspaper business from one corporation to another corporation. In the ruling, the taxpayer received advance payments for subscriptions that it had elected to defer under section 455. The taxpayer subsequently sold its newspaper business, and the purchaser agreed to assume the taxpayer's liability to fulfill the subscriptions. The taxpayer received $5x dollars for the newspaper business and paid the buyer $1x dollars to compensate the buyer for assuming the taxpayer's liability for prepaid subscriptions. The ruling concluded that the separate amount paid by the seller to the buyer for its assumption of the seller's deferred revenue liability was deductible under section 162(a). In reaching this conclusion, the IRS noted that if the seller had used the funds it had paid to the purchaser to extinguish the liability by refunding the prepaid subscriptions, the seller would have been entitled to a deduction under section 162. Thus, the IRS did not perceive that there should be a different result in a situation where the seller pays a buyer to assume the seller's deferred revenue liability.

Subsequent to the issuance of Rev. Rul. 68-112, the IRS published Rev. Rul. 71-450,[9] which amplified the holding in Rev. Rul. 68-112, to address the consequences to the buyer in a transaction characterized using the Separate Transaction Approach. The ruling concluded that the payment the buyer received from the seller to assume the liability to fulfill the subscriptions was includible in income under section 61.

Revenue Ruling 76-520[10] addresses the treatment of costs incurred by the buyer using the Separate Transaction Approach. In the ruling, a publishing corporation, P, purchased all the stock of S, another publishing corporation. P subsequently caused liquidation of S under section 332, with the tax basis of the assets acquired from S determined under old section 334(b)(2). In the acquisition, P assumed the obligation of S to fulfill the existing subscription contracts with S's prepaid subscribers, which S had entered into prior to the stock acquisition. The ruling addressed whether P may deduct, as an ordinary and necessary business expense under section 162, the costs incurred in fulfilling the obligation assumed for later delivery of the periodicals under the prepaid subscription agreements entered into prior to P's acquisition of S's stock. The IRS held that when a corporation acquires the stock of another corporation and then liquidates the acquired corporation under old section 334(b)(2), any payments from the acquirer to service prepaid subscription contracts assumed must be capitalized into the assets acquired.

[8] 1968-1 C.B. 62
[9] 1971-2 C.B. 78.
[10] 1976-2 C.B. 42.

Issues with the Separate Transaction Approach

The Separate Transaction Approach raises a number of questions for both the seller and the buyer with respect to the assumption of a deferred revenue liability. First, although the court held in *Pierce* that the seller was entitled to a deduction for the "deemed payment" to the buyer to assume the seller's deferred revenue liability, it is not entirely clear whether the seller's "deemed payment" should be the full amount of the deferred revenue liability (i.e., advance payments received by the seller not yet recognized as income), the anticipated cost to satisfy the deferred revenue liability, or some other amount. Generally, when revenue for services, goods, subscriptions, membership dues and other items is deferred under a tax deferral provision (e.g., Rev. Proc. 2004-34, Treas. Reg. § 1.451-5, etc.), the deferred revenue liability shown on the seller's tax basis balance sheet reflects the amount of the advance payment received but unrecognized, which is effectively both the seller's expected cost to perform and its expected profit. *Pierce* did not factor in cost of performance when determining the amount of the "deemed payment" that is deductible by the seller. Rather, the court's holding in *Pierce* suggests that the seller's deduction for the "deemed payment" equals the full amount of the deferred revenue liability reflected on the seller's tax basis balance sheet. Thus, under *Piece*, the entire profit attributable to the deferred revenue liability is effectively shifted to the buyer. However, if the "deemed payment" were valued at the expected cost to satisfy the deferred revenue liability, some or all of the seller's expected profit would be recognized by the seller.

In addition to issues related to determining the value of the deferred revenue liability assumed by the buyer, the timing for tax purposes of the revenue recognition by the buyer is also unclear. Specifically, where the seller pays the buyer for the buyer's assumption of the seller's deferred revenue liability, the requirement for the buyer to include the full amount of the deemed payment in gross income is not intuitive given the fact that the buyer will have no accession to wealth for the portion of the payment attributable to the buyer's future cost of performance.

Further, it is not clear whether the buyer is permitted to defer revenue attributable to the payment received for assuming the seller's deferred revenue liability under any of the tax deferral provisions. Although *Pierce* dealt with the seller's tax treatment of a deferred revenue liability assumed by the buyer, the court observed that if the buyer were on the accrual method of accounting, it should be eligible to defer the recognition of revenue attributable to the deemed payment for the assumption of the deferred revenue liability. Apart from the court's observation in *Pierce*, there is no guidance addressing this issue.

The holding in Rev. Rul. 76-520 also presents challenges for the buyer. Specifically, Rev. Rul. 76-520 concluded that a buyer is obligated to capitalize the cost of performance with respect to prepaid subscription contracts entered into prior to the buyer acquiring all the assets of the trade or business and assuming its prepaid subscription obligations. However, the costs incurred to prepare the periodicals at the news stands were deducible when incurred. When applying this holding in practice, it is often difficult for the buyer to segregate its operating expenses between those related to satisfaction of the assumed deferred revenue liability and those related to the satisfaction of liabilities arising in the ordinary course of the buyer's trade or business.[11]

[11] The facts in Rev. Rul. 76-520 do not indicate whether, as a result of the liquidation, the taxpayer recognized revenue in connection with the assumption of the deferred subscription liability. Thus, it is unclear whether the buyer is required to capitalize costs to satisfy the deferred revenue liability if also required to recognize revenue in connection with a deemed payment from the seller under the Separate Transaction Approach. Certainly, if the buyer assumed

Assumed Liability Approach

Overview

A second approach is to treat for tax purposes the assumption of a deferred revenue liability by one party (the buyer) in exchange for property from the other party (the seller) as a purchase transaction (hereafter referred to as the "Assumed Liability Approach"). Under the Assumed Liability Approach, the buyer is treated for tax purposes as purchasing the property from the seller for consideration equal to the liability assumed. The purchase of property is not a taxable event to the buyer; therefore, the buyer does not recognize income. Rather, the buyer adjusts the tax basis of the property acquired when costs are incurred to satisfy the liability, in the same manner as contingent liabilities are typically accounted for in a taxable asset acquisition.

In *Commissioner v. Oxford Paper Co.*,[12] the seller transferred a lease obligation to the buyer along with a building and cash. The buyer applied the Separate Transaction Approach and for tax purposes recognized income up front and recorded tax basis in the building acquired equal to its fair market value. The buyer used its deductions, including the depreciation incurred on the building, to offset its income. The IRS disallowed the depreciation deductions by arguing the Assumed Liability Approach should apply. After losing in District Court, the buyer litigated its position in Tax Court. The Tax Court recognized that both the Separate Transaction Approach and the Assumed Liability Approach could be appropriate. However, the Tax Court held that because the lease obligation assumed was the "most important part" of the transaction, emphasis should not be placed on the acquisition of the building. Rather, because the seller "wanted to be relieved from the burden of the lease," the Tax Court agreed with the buyer's use of the Separate Transaction Approach to treat the cash and property as a payment to the buyer for undertaking the obligations under the lease. On appeal, the Second Circuit held that the buyer should not have recognized income for the fair market value of the building transferred. Rather, the court found that the Assumed Liability Approach was appropriate. As such, the court held and viewed for tax purposes the transaction as a purchase of the assets for an amount equal to the liability assumed less the cash received. The Second Circuit determined that the amount paid by the buyer (*i.e.*, the liabilities assumed less cash received) represented the proper tax basis in the assets transferred to the buyer and that the recognition of income was not appropriate in a purchase transaction.

The IRS has several private letter rulings addressing the federal income tax consequences that result from the sale of an interest in a nuclear power plant and the associated assets and liabilities, including the nuclear decommissioning liability (the "Nuclear Decommissioning PLRs"). In each of these rulings, the IRS has considered, but has not applied, the holding in Rev. Rul. 71-450 to the buyer. The IRS distinguished the facts in the private letter rulings from those in Rev. Rul. 71-450 on the basis that the purchaser in Rev. Rul. 71-450 agreed to assume the subscription liability in exchange for a separate cash payment. On that basis, the IRS in PLR 200546036 noted:

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the deferred revenue liability from the seller by way of a separately negotiated payment, the buyer would be entitled to take into account (i.e., deduct or, if subject to section 263A, capitalize) the costs incurred to satisfy the liability. Notwithstanding that fact, the ruling suggests that any costs incurred by the buyer to satisfy the deferred revenue liability must be capitalized into the basis of the acquired assets. Such an interpretation appears to be inconsistent with the Separate Transaction Approach and presents challenges for buyers trying to determine the appropriate method of accounting for these costs.

[12] 194 F.2d 190 (2nd Cir. 1952).

> While an exception to the general rule that a taxpayer does not realize gross income upon its purchase of the assets of a business is set forth in Rev. Rul. 71-450, 1971-2 C.B. 78, such ruling does not apply to the present case. . . We assume that Buyer's basis attributable to the decommissioning liability is governed by section 461(h) and that the consideration furnished by Buyer will be allocated pursuant to the residual method under section 1060 and the regulations thereunder.[13]

The regulations under section 461 address the tax consequences to the seller when the Assumed Liability Approach is used. Section 461(a) provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. Treasury Reg. § 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability is determinable with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

Treasury Reg. §1.461-4(d)(5) provides an exception to the general rules for economic performance. The regulation states that if, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a trade or business liability that the taxpayer would have been entitled to incur as of the date of the sale without taking into consideration the economic performance requirement, economic performance with respect to that liability is considered to occur as the taxpayer properly includes the amount of the liability in the amount realized for the transaction.

Issues with the Assumed Liability Approach

Although the court in *Pierce* allowed the seller to claim a deduction for the "deemed payment" to the buyer for the assumption of the deferred revenue liability, the *Pierce* decision predated the economic performance rules under section 461(h). Therefore, under *Pierce*, the timing of the seller's deduction for the "deemed payment" of the deferred revenue obligation was not an issue.

There is no authority that addresses how the provisions of Treas. Reg. § 1.461-4(d)(5) apply to the assumption of the seller's deferred revenue liability. Thus, it is unclear whether the seller's "deemed payment" to the buyer should be taken into account for tax purposes at the time of the sale (i.e., because the liability to perform is fixed and determinable and economic performance occurs as the payment is made to the buyer) or whether the seller is entitled to a deduction only to the extent costs are incurred by the buyer to satisfy the deferred revenue liability (i.e., because the liability to perform is contingent).

The Assumed Liability Approach also presents issues for the buyer. In an applicable asset acquisition, the regulations under section 1060 require a buyer to allocate consideration among the acquired assets in accordance with the residual allocation method. Pursuant to the regulations under section 1060, the buyer's consideration includes the total cost incurred to acquire the trade or business, including cash and the fair value of other property paid in exchange for the assets, as well as any assumed liabilities, which would include the seller's deferred revenue liability. Although it is clear for tax purposes that the buyer must capitalize costs incurred to satisfy the assumed deferred revenue liability into the tax basis of the acquired assets under the Assumed

[13] I.R.S. Priv. Ltr. Rul. 200546036 (Jul. 28, 2005).

Liability Approach, practically, it is difficult for the buyer to comply because of an inability to segregate costs between those related to the assumed deferred revenue liability and those incurred to satisfy obligations arising in the ordinary course of the buyer's trade or business.

III. Examples

In this section, we present two examples to illustrate the tax application of the approaches described above with respect to the transfer of a deferred revenue liability in a taxable asset acquisition. These examples represent hypothetical scenarios of the type often seen in such transactions.

Facts related to all scenarios prior to the taxable asset acquisition transaction:

- During year of sale, Seller received $100 from customer and uses the Deferral Method under Rev. Proc. 2004-34, and (but for the sale) no amount related to the $100 must be reported in taxable income in the year of sale.

- Journal entry to record the initial receipt of cash by Seller is as follows:

  DR Cash $100

  CR Deferred Revenue $100

- By the transaction date, Seller's tax basis balance sheet is as follows:

	Basis	**FMV**
Cash	$0	$0
Fixed assets	100	100
Goodwill	0	150
Deferred revenue	(100)	(100)

- In all of the scenarios, Buyer purchases assets and assumes liabilities from Seller. These scenarios assume that Buyer and Seller have agreed on a value of $100 for the assumed deferred revenue liability.

Scenario 1: Buyer assumes the Seller's deferred revenue liability in a separately negotiated payment

Buyer pays Seller $250 for all of the assets, and Seller pays Buyer $100 to assume its deferred revenue liability.

SELLER CONSEQUENCES		
	DR	**CR**
Cash	250	
Fixed assets		100
Goodwill		-0-
Gain on sale		150
Seller reverses the initial journal entry because its liability has ceased as follows		
Deferred revenue	100	
Revenue		100
Seller records the separate payment and deduction under Rev. Rul. 68-112 *as follows*		
Pierce deduction	100	
Cash		100
Net taxable income impact to seller		**150**

BUYER CONSEQUENCES		
	DR	**CR**
Cash		250
Fixed assets	100	
Goodwill	150	
Cash	100	
Revenue/Deferred Revenue		100
Deduction/Goodwill**	100	
Cash**		100
***In a subsequent tax year, when Buyer incurs the liability for performance with respect to the deferred revenue (in this example $100), it deduct or capitalize the costs of performance*		
Net taxable income impact on buyer		**-0-**

Under this scenario, a separate payment is negotiated between Buyer and Seller to compensate Buyer for the assumption of the deferred revenue liability. Applying the Separate Transaction Approach described above, for tax purposes, Seller recognizes gain on the sale of the fixed assets in the amount of $150, ordinary income of $100 for the deferred revenue and an ordinary deduction of $100 for the payment to Buyer.

Buyer has tax basis of $250 in the acquired assets, ordinary income of $100 related to the payment received from Seller, and will account for the costs to satisfy the deferred revenue liability as incurred. For tax purposes, the Buyer may recognize the income in the year the payment is received or may apply one of the deferral provisions to the extent applicable. [14]

Scenario 2: Buyer assumes Seller's deferred revenue liability

There is no separately negotiated payment, but the sales price reflects Buyer's assumption of the deferred revenue liability. Buyer pays Seller $150 for all assets and liabilities.

[14] In Scenario One, there is an actual payment from Seller to Buyer. However, the same analysis should apply to a deemed payment under the Separate Transaction Approach described in Scenario Two.

SELLER CONSEQUENCES		
	DR	**CR**
Separate Transaction Approach		
Cash	250[15]	
Fixed assets		100
Goodwill		-0-
Gain on sale		150
Seller reverses the initial journal entry because its liability has ceased as follows:		
Deferred revenue	100	
Revenue		100
Deduction for deemed payment to Buyer	100	
Cash		100
Net taxable income impact to Seller		**150**

BUYER CONSEQUENCES		
	DR	**CR**
Separate Transaction Approach		
Cash		250
Fixed Assets	100	
Goodwill	150	
Revenue		100
Additional Goodwill or deduction?	100	
Net taxable income impact on Buyer		**-0-**

SELLER CONSEQUENCES		
	DR	**CR**
Assumed Liability Approach[16]		
Cash	150	
Deemed payment from buyer for assumed liability	100	
Fixed assets		100
Goodwill		-0-
Gain on sale		150
Seller reverses the initial journal entry because its liability has ceased as follows:		
Deferred revenue	100	
Revenue		100
Deduction	100	
Deemed payment to buyer for assumed liability		100
Net taxable income impact to Seller		**150**

BUYER CONSEQUENCES		
	DR	**CR**
Assumed Liability Approach		
Cash		150
Fixed Assets	100	
Goodwill	50	
Goodwill**	100	
Cash**		100
*****In a subsequent tax year, when Buyer incurs the liability for performance with respect to the deferred revenue (in this example $100), it capitalizes the costs as additional goodwill.***		
Net taxable income impact on Buyer		**-0-**

[15] Under the Separate Transaction Approach, Buyer is deemed to have made a payment for $250 to Seller for the assets such that for tax purposes, it would be included in Seller's amount realized and increase Buyer's basis in the assets purchased.

[16] If Buyer fails to obtain a discount on the purchase price due to the assumption of the deferred revenue liability, the Assumed Liability Approach would produce the same tax consequences as Scenario 2 where the value of the deferred revenue liability assumed by Buyer was agreed upon by the parties.

Under this scenario, the purchase price of the assets is reduced because Buyer will assume Seller's liability related to the deferred revenue.

Under the Separate Transaction Approach, the effect on Seller is identical to the result in Scenario 1. Seller recognizes gain of $150 on the sale of the fixed assets, ordinary income of $100 for the amount of the deferred revenue, and an ordinary deduction of $100 for the deemed payment to Buyer. For tax purposes, Buyer has a tax basis of $150 cash paid in the assets acquired plus an additional $100 related to the deemed payment from Seller treated as ordinary income. In addition, for tax purposes, Buyer will account for the actual costs as the liability is incurred.

Under the Assumed Liability Approach, the tax consequences to Seller are less clear. Seller is required under Rev. Proc. 2004-34 to accelerate the advance payment into income in the year of the sale; thus, it would have ordinary income of $100. Additionally, for tax purposes, Seller's amount realized is increased by the amount of the liability assumed, or $100. Thus, Seller would recognize gain on the sale of $150. However, under the Assumed Liability Approach, it is unclear when Seller is entitled to a deduction as a result of Buyer's assumption of the deferred revenue liability (i.e., at the time of sale or at the time Buyer incurs costs to satisfy the liability).

The tax effect of the Assumed Liability Approach to Buyer is that no income is recognized upon the assumption of the deferred revenue liability because there is no accession to wealth. Rather, Buyer adjusts the tax basis of the property acquired as Buyer incurs costs to satisfy the deferred revenue liability.

IV. Assumed Liability Safe Harbor Proposal

The AICPA believes that a safe harbor under which the buyer and seller agree to the value and tax treatment of the deferred revenue liability assumed by the buyer in a taxable asset acquisition would reduce controversy between taxpayers and the IRS and provide certainty for taxpayers that engage in such transactions. Such a safe harbor also would provide for consistency in the tax treatment by buyers and sellers. Accordingly, the AICPA has developed and proposes that the IRS consider issuing the following draft Rev. Proc. with the AICPA suggested safe harbor.

* * * * *

REVENUE PROCEDURE 2015-XX

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting for deferred revenue liabilities assumed by a purchaser in an applicable asset acquisition under section 1060.

SECTION 2. DEFINITION

The following definition applies solely for purposes of this revenue procedure.

> .01 Applicable liability. An applicable liability is an obligation arising from an advance payment received by a seller who has deferred recognition of such advance payment under section 455, section 456, Treas. Reg. § 1.451-5, Rev. Proc. 2004-34, 2004-1 C.B. 991,

Rev. Proc. 2011-17, 2011-1 C.B. 441, Rev. Proc. 2011-18, 2011-1 C.B. 443, or other guidance published in the Federal Register permitting deferred recognition of advance payments, which obligation is assumed by the buyer in an applicable asset acquisition as defined in section 1060(c), to the extent that the buyer and seller agree in writing to the value of such obligation.

SECTION 3. SCOPE

This revenue procedure applies in the case of an applicable liability (as defined in section 2 of this revenue procedure) for which the taxpayer makes the safe harbor election described in section 4 of this revenue procedure.

SECTION 4. SAFE HARBOR ELECTION

The Service will not challenge the following treatment of an applicable liability if -

(1) The buyer -
   a. Attaches a statement to its original federal income tax return for the taxable year the applicable liability is assumed by the buyer, stating that the buyer is electing the safe harbor pursuant to a joint written agreement with the seller to make the election, providing the date of the transaction, stating the value of the applicable liability, and stating that the value was agreed upon in writing by the buyer and seller,
   b. Treats the value of the applicable liability as consideration paid in the applicable asset acquisition and allocates such value together with all other consideration paid in the transaction among the assets transferred under section 1060,
   c. Recognizes no income for the assumption of the liability, and
   d. Deducts any costs incurred in excess of the agreed-upon value of the applicable liability in the taxable year in which such excess costs are incurred.

(2) The seller –
   a. Attaches a statement to its original federal income tax return for the taxable year the applicable liability is assumed by the buyer, stating that the taxpayer is electing the safe harbor pursuant to a joint written agreement with the buyer to make the election, providing the date of the transaction, stating the value of the applicable liability, and stating that the value was agreed upon in writing by the buyer and seller,
   b. Treats the value of the applicable liability as consideration received in the applicable asset acquisition and allocates such value together with all other consideration received in the transaction among the assets transferred under section 1060, and
   c. Deducts the agreed-upon value of the applicable liability in the taxable year in which the applicable liability is assumed by the buyer.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for elections made with respect to transactions occurring in taxable years beginning on or after January 1, 2015.

V. Conclusion

For the reasons stated above, the AICPA respectfully recommends that the IRS consider providing guidance in the form of a safe harbor, such as the one discussed above, to be used at the option of the taxpayer. Such a safe harbor would require agreement between the buyer and seller as to the value of the assumed liability and would allow both parties to consistently treat for tax purposes such amount as an assumed liability.

We believe the safe harbor approach described above will provide taxpayers with clarity on the tax accounting treatment of deferred revenue in taxable asset acquisitions while also ensuring there is parity in the tax treatment between the buyer and the seller. Additionally, the AICPA believes the proposed approach would provide meaningful simplification for buyers and sellers opting to apply the safe harbor.