ROBERTS & HOLLAND LLP

February 19, 2004

Treatment of Contingent Liabilities Assumed in Purchase of Assets

By: Elliot Pisem and David E. Kahen

If the assets of a business are acquired in a taxable transaction such as the purchase of assets for cash, the consideration to the seller for tax purposes – and the purchaser's basis for the assets – includes not only the purchase price paid in cash but also liabilities assumed or taken subject to.

A contingent liability assumed by the purchaser is generally not taken into account for these purposes until the amount of the liability is fixed. At that time, the amount paid or incurred is generally required to be capitalized as part of the cost of acquisition. A common area of controversy between taxpayers and the Internal Revenue Service is the extent to which amounts paid to satisfy contingent liabilities assumed in connection with the purchase of a business must be capitalized rather than deducted when paid or incurred.

A recent decision of the Seventh Circuit Court of Appeals, affirming a decision of the Tax Court, addresses the treatment of contingent liabilities in a context that underscores the extent to which a third party claim not believed to represent a substantial exposure at the time of an acquisition can end up being an unpleasant surprise to the purchaser from both a financial and tax perspective.

Illinois Tool Works

In Illinois Tool Works Inc. v. Commissioner (No. 02-1239 (7th Cir. 2004)), the contingent liability at issue related to a business known as the DeVilbiss Co. ("DeVilbiss") that manufactured and sold computer-controlled paint-spray robots.
In 1975, Jerome Lemelson, an inventor, contacted DeVilbiss, which at that time was a division of Champion Spark Plug, Inc. ("Champion"), to offer to license to DeVilbiss certain patents. DeVilbiss did not accept the offer. In 1979, Lemelson notified DeVilbiss (through counsel) that certain products sold by DeVilbiss might be infringing on Lemelson patents. DeVilbiss denied any infringement.

Lemelson then brought two patent infringement suits, including one lawsuit filed in a U.S. district court against Champion.

Subsequently, Champion sold DeVilbiss, but the second suit remained pending at that time and at the time the buyer from Champion sold the assets of DeVilbiss to ITW. According to the decision of the Tax Court below, ITW's staff concluded during the due diligence process which preceded the sale that legal fees of approximately $400,000 would likely be incurred in defending the Lemelson lawsuit, but that ITW would almost certainly prevail in the patent infringement claim. ITW assumed liability for the lawsuit, and the Court of Appeals decision states that a cash reserve of $350,000 was negotiated to pay for legal fees expected to be incurred in defending this suit.

The lawsuit went to trial less than a year after the acquisition by ITW. During the trial, ITW rejected a final settlement offer made by Lemelson to settle the suit for an amount in the neighborhood of $1 million.

The jury then returned a verdict finding that there had been willful infringement by DeVilbiss of a patent owned by Lemelson, based in part on Champion's failure to obtain an authoritative opinion regarding the infringement issue until shortly before trial. The jury awarded damages of $4.6 million, with $6.3 million of prejudgment interest.

The district court then doubled the damages by reason of the finding of willful infringement. After all appeals were exhausted, ITW paid in 1992 a judgment of $17.1 million that included damages and prejudgment interest of $15.6 million and post-judgment interest of $1.5 million.

The ITW tax return for 1992 reflected a capitalization of $1 million of the payment as a cost of acquiring DeVilbiss, but deducted on a current basis the remainder of the payment.

The 1992 tax return of ITW included a Form 8275-R, a disclosure statement filed to avoid certain additions to tax with respect to a tax return position that is contrary to a regulation. The disclosure statement indicated that the rationale for the bifurcated treatment of the

$17 million payment (i.e., the capitalization of only $1 million of that amount) was that, since the taxpayer had the opportunity to settle the suit after the acquisition for approximately $1 million, the portion of the amount paid that exceeded $1 million was attributable to the decision by ITW to reject Lemelson's last settlement offer, rather than to the asset acquisition and the assumption of the liability represented by the Lemelson lawsuit.

In the Tax Court proceedings, the Commissioner conceded that $2.2 million of the $17.1 million payment was allowable as post-acquisition interest expense, and apparently also conceded that an additional $7 million of the judgment would, if capitalized, be deductible in 1992 as allocable to assets that ITW had acquired from DeVilbiss and had then disposed of by that year. Thus, the issue was whether the balance of almost $7 million was currently deductible as a trade or business expense (the position taken by ITW on its tax return) or required to be capitalized as a cost of acquisition.

The opinion of the Tax Court commences its analysis by noting the general requirement, reflected in regulations under Internal Revenue Code section 263, that the cost of acquisition of property with a useful life substantially beyond the end of the taxable year must be capitalized (see Treas. Reg. section 1.263(a)-2). The opinion further observes that, "[g]enerally, the payment of a liability of a preceding owner of property by the person acquiring such property, whether or not such liability was fixed or contingent at the time such property was acquired, is not an ordinary and necessary business expense" (citations omitted).

ITW made several arguments before the Tax Court as to why the payment of the judgment should be viewed as an ordinary and necessary business expense. It argued that the amount of the payment made in satisfaction of the lawsuit should not be required to be capitalized because the payment was highly speculative, and unexpected at the time of purchase.

ITW further argued, in the alternative, that (i) the payment would have been deductible if made by DeVilbiss, and should therefore retain its deductible character after ITW as the purchaser became the party in interest, and (ii) that the final judgment was a result of ITW's actions and decisions in defending the lawsuit in the course of its business operations, and should therefore be viewed as an ordinary and necessary business expense.

The IRS argued, to the contrary, that the capitalization of the payment as a liability assumed in connection with the acquisition was required because the acquired assets were expected to produce long-term benefits to ITW by reason of their use in ITW's business, and that the total payment must be included in the cost of the assets acquired regardless of whether the amount ultimately paid was unexpected or a remote possibility at the time of the acquisition.

The Tax Court held for the Commissioner, and its opinion cites David R. Webb Co. v. Commissioner (77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983)) as controlling. In Webb, the taxpayer, in connection with the purchase of the assets of a corporation, assumed a liability to pay a lifetime pension to the widow of a corporate officer. The Tax Court and, on appeal, the Seventh Circuit Court of Appeals found that the pension payments had to be capitalized as part of the cost of the assets.

On appeal, ITW chose to rely solely on the argument that $16 million of the $17 million payment was attributable to its post-acquisition business decision to turn down Lemelson's offer to settle during the trial of the patent suit; ITW abandoned the other arguments described above. The Court of Appeals characterized ITW's argument on appeal as a "novel mea culpa argument," and dismissed it based on a legal analysis similar to that set forth in the opinion of the Tax Court.

As did the Tax Court below, the Court of Appeals also considered but ultimately dismissed the argument by ITW that its decision in Nahey v. Commissioner (196 F.3d 866 (7th Cir. 1999)) supported the petitioner's position.

The issue in Nahey was whether the <u>receipt</u> of proceeds of litigation that was prosecuted and ultimately won by the purchaser of assets of a corporation that initially held the claim resulted in ordinary income or capital gain. The Court of Appeals held there that the recovery resulted in ordinary income to the purchaser, at least in part because collection on the claim by the seller would have resulted in ordinary income to the seller.

Both the Tax Court and the Court of Appeals in Illinois Tool found this analogy between the treatment of the <u>purchaser</u> of a claim in Nahey and the treatment of a party <u>assuming</u> <u>liability</u> under a claim in the present case to be unpersuasive, with the Tax Court observing simply that to apply the preservation-of-character concept from Nahey to the Illinois Tool context would contravene the "consistently applied rule" that the payment of assumed liabilities must be capitalized.[1]

The Court of Appeals in Illinois Tool also turned back the petitioner's efforts to rely on A. E. Staley Mfg. Co. v. Commissioner (119 F.3d 482 (1997)), in which the Seventh Circuit Court of Appeals, reversing the Tax Court, concluded that fees paid to investment bankers in an ultimately unsuccessful effort to avert a hostile takeover could be currently deducted as not capital in nature. Staley appeared readily distinguishable because the investment banking fees incurred by the target corporation to oppose the takeover were not incurred by it to facilitate a capital transaction, whereas the assumption of liability for the Lemelson suit was clearly part of the capital cost of acquiring the DeVilbiss assets.

Unlike the Tax Court decision below, the Court of Appeals decision in Illinois Tool emphasized the facts that ITW "knowingly" assumed responsibility for the lawsuit and that the lawsuit "arriv[ed] in ITW's hands fully formed." These references seem to leave the door open, at least a crack, to the argument in appropriate circumstances that capitalization should not be required where an assumed obligition is attributable to pre-acquisition events but has not matured to the point of being identifiable with specificity at the time of an acquisition; or where the ultimate liability is determined

in meaningful part by reference to one or more post-acquisition developments.

Observations

Overall, the denial of an immediate deduction for non-interest portions of the payment made by ITW was not a surprising result on the facts of the case. Could the capitalization result have been avoided through planning?

ITW could, of course, have settled the lawsuit before judgment, in which event it would have had a much smaller amount to capitalize. Setting aside the benefits of 20-20 hindsight, query whether it was fully appreciated, at the time of settlement discussions before and contemporaneously with the trial of the Lemelson patent infringement claim, that the payment of an adverse judgment would probably not be immediately deductible; and, if not, whether that knowledge would have provided ITW with a greater incentive to limit its loss exposure through a settlement before judgment.

Alternatively, if ITW had been able to persuade the seller of DeVilbiss to retain liability for the Lemelson lawsuit, perhaps in consideration of a relatively modest increase in the purchase price (assuming, of course, that retention of the liability would have been feasible from a non-tax perspective), any payment of the judgment by the seller of the DeVilbiss assets would likely either have been deductible by it or be taken into account in decreasing its gain or increasing its loss from the sale to ITW.

---

[1] Some of the discussion in *Nahey* suggests that the decision may have turned on the fact that the receipt of payment of the judgment would not constitute a sale or exchange. Unfortunately, the exact rationale for the Court of Appeals decision in *Nahey* is not entirely clear.

Reprinted with permission from the February 19, 2004 edition of the *New York Law Journal*
© 2017 ALM Media Properties, LLC,
All rights reserved.
Further duplication without permission is prohibited.
ALMReprints.com – 877-257-3382 – reprints@alm.com.