ROBERTS & HOLLAND LLP

December 18, 2025

# Tax Treatment of Payments to Seller's Creditors: *Temnorod v. Commissioner*

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Originally Published in the New York Law Journal

If a buyer of property assumes a liability of the seller or acquires property subject to a liability, the seller's amount realized for tax purposes generally includes the amount of the liability (Treas. Reg. § 1.1001-2(a)). The buyer in turn generally includes the liability, as an acquisition cost, in its tax basis for the property (see, e.g., Treas. Reg. § 1.1060-1(c)) and cannot claim a current deduction for paying the liability, whether payment is made at the time of the acquisition or at a later date.

Application of these basic tax rules can become challenging where the assumed liability is also attributable to business activities of the buyer. The Tax Court in Temnorod v. Commissioner (TC Memo 2025-127) very recently addressed the treatment of such liabilities in the context of a purchase of assets of a business in bankruptcy proceedings. The purchaser reflected on its tax return the purchaser's funding of the payment of liabilities as costs of goods sold in the year of the acquisition. The court found that the position taken on the purchaser's tax return was at odds with the characterization of the liabilities in the asset purchase agreement with the bankrupt company and on an amended tax return of the seller (which was under common control with the purchaser), and ultimately agreed with the government's position that the payments made to satisfy the liabilities were required to be capitalized by the purchaser into the basis of longer-lived assets and could not be deducted in the year of the acquisition.

Facts in Temnorod

Broadvox, LLC (BV) was formed in 2001 to exploit "Voice over Internet Protocol" (VoIP) technology used to make phone calls via the internet. To provide this telecommunications service, BV entered into carrier service agreements (CSAs) with several competitive local exchange carriers (CLECs) which in turn routed the calls through incumbent local exchange carriers (ILECs).

About three years later, the owners of BV formed their own CLEC, Infotelecom, to enter into interconnection agreements with ILECs. Infotelecom was classified as a partnership for income tax purposes.

Thereafter, the ownership of BV was restructured such that BV became owned by BV Holding. BV Holding's sole shareholder was Broadvox, Inc., an S corporation. Each of BV and BV Holding was treated as a disregarded entity for Federal tax purposes. The principal shareholders of Broadvox were also the owners of Infotelecom.

Under a CSA between BV and Infotelecom, BV was required to pay to Infotelecom all charges incurred by Infotelecom in completing BV call traffic through ILECs, including charges incurred by Infotelecom under interconnection agreements with AT&T and Verizon. However, Infotelecom paid AT&T and Verizon less than the amounts that AT&T and Verizon believed to be owed under the interconnection agreements. Infotelecom billed BV for interconnection charges at rates substantially equal to what Infotelecom actually paid to AT&T and Verizon.

In 2011, AT&T threatened to terminate its interconnection agreement with Infotelecom unless payment of the additional amounts AT&T believed to be owed under that agreement was funded through an escrow arrangement. Infotelecom sued AT&T and commenced proceedings before state regulatory agencies, apparently to dispute AT&T's bills and to maintain the interconnection arrangement, but then filed for bankruptcy under chapter 11. In the ensuing bankruptcy proceedings, AT&T and Verizon submitted claims totaling approximately $24 million.

The bankruptcy proceedings culminated in orders under which Infotelecom sold substantially all of its assets to BV Holding in 2012. The agreement governing that sale provided for assignment of Infotelecom's interests in its interconnection agreements to BV Holding, in consideration of a "Cash Purchase Price" of $1,630,000.

Most of the Cash Purchase Price was used to pay $1,562,000 to AT&T. In addition, and as part of the overall transaction, BV Holding paid $1,600,000 to Verizon. After these payments were made, BV Holding was discharged from any further liability to Verizon or AT&T, whether under the assigned interconnection agreements or otherwise, by reason of the purchase.

The Form 1120S Federal tax return of Broadvox for 2012 reported the amount paid to Verizon and an amount roughly equal to the total amount paid to AT&T as costs of goods sold. That resulted in Broadvox's having an overall loss for 2012 that flowed up to its shareholders and was used by them to offset income from other sources for 2012; the loss was also carried back by certain shareholders to their 2010 tax years. Following examination by the IRS of the 2012 Broadvox return, however, the losses reported by Broadvox were disallowed to the extent attributable to the inclusion of the payments to AT&T and Verizon (the Payments) in costs of goods sold.

## Discussion

The memorandum decision of the Tax Court in Temnorod first discussed whether the Payments could be taken into account by Broadvox as costs of goods sold in computing its gross income. Based on cases and the definition in a regulation under IRC section 61 of "gross income," the court observed that the cost of goods sold is relevant to the computation of gross income of businesses involving the sale of goods, such as mining, manufacturing, and the sale of merchandise, but not to the computation of gross income of a business consisting of the provision of services. Taking into account petitioners' agreement that Broadvox was a service provider, Broadvox could not subtract costs of goods sold in computing its gross income.

The court then addressed whether the Payments constituted, as argued by the petitioners, ordinary and necessary business expenses deductible in computing taxable income, or, as asserted by the government, expenditures required to be capitalized as part of the cost of the assets purchased under the asset purchase agreement, pursuant to IRC section 263(a) and the extensive case law applying that provision. Section 263(a) by its terms prohibits the deduction of any amount required to be capitalized.

The petitioners asserted that, but for the bankruptcy settlement, AT&T and Verizon would likely have pursued Broadvox directly for satisfaction of their claims for underpayment of interconnection charges relating to Broadvox call traffic, on the basis that Broadvox was directly liable for Infotelecom's debts (perhaps under an agency or similar rationale). Alternatively, AT&T and Verizon could have sought to convert the chapter 11 bankruptcy proceeding to a chapter 7 proceeding. The petitioners further asserted that, after such a conversion, a bankruptcy trustee

would be appointed who would then sue Broadvox to enforce Infotelecom's rights under its CSA with Broadvox, so to maximize recoveries for the benefit of Infotelecom's creditors, AT&T and Verizon.

The government argued in response that the petitioners' position was inconsistent with the asset purchase agreement, which provided that the purchase price for the assets included the Cash Purchase Price (most of which was then designated as to be paid to AT&T) and satisfaction of Infotelecom liabilities that included the amount to be paid to Verizon. The government further asserted that, under the "strong proof rule" articulated in Commissioner v. Danielson (378 F.2d 771 (3rd Cir. 1967)) and cases cited therein, the petitioners' tax consequences had to be determined in a manner consistent with how the Payments were characterized under the asset purchase agreement, at least absent proof that the agreement was unenforceable or that the allocation indicated by the agreement was clearly erroneous. The petitioners apparently countered that the asset purchase agreement did not directly address the character of the liabilities ultimately satisfied with the Payments or unambiguously allocate the liabilities as consideration for the assets acquired.

The court acknowledged that "there are limits to the Danielson and strong proof rules, in cases where there is some ambiguity in the allocations of payments under contract," but ultimately sided with the government. The court found that the petitioners did not carry their burden of proof that the Payments made to discharge the liabilities to AT&T and Verizon were anything other than amounts paid by Broadvox to acquire the assets of Infotelecom.

The opinion also noted that Infotelecom filed an amended tax return for 2012 which stated that an amount equal to the Payments had been "inadvertently recorded as gross receipts." That apparent treatment on its original return for 2012 could be consistent with the thrust of the petitioners' argument that the Payments were made in satisfaction of obligations of Broadvox arising under its CSA with Infotelecom, rather than to acquire assets under the asset purchase agreement. The amended return treated the Payments as having been made for goodwill, a position hard to reconcile with the position of the shareholders of Broadvox before the court that the Payments were in substance to satisfy obligations of Broadvox independent of the asset purchase agreement.

## Observations

Based only on the circumstances as set forth in the Temnorod opinion, the position of the petitioners that the Payments were ordinary and necessary business expenses of Broadvox may have been more consistent with the actual circumstances than the government's position. The opinion references in a footnote petitioners' assertion, supported by testimony of their expert witness, that the interconnection agreements assigned by Infotelecom had no value. If the principal activity of Infotelecom was providing services to one other business entity under common ownership (that is, Broadvox), that further suggests that Infotelecom did not have valuable goodwill.

The terms of the asset purchase agreement, however, were not in alignment with the petitioners' assertions to the Tax Court as to the true nature of the Payments. Further, the position taken in the amended return of Infotelecom, presumably to improve the tax position of its owners, that the Payments were consideration to Infotelecom for goodwill, further undermined the petitioners' position that the Payments were deductible by the purchaser.

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