

KEY SERVICE INSIGHTS

BUSINESS TAX NEWSLETTER

SELLING A BUSINESS:

PLAN CAREFULLY FOR ASSUMED LIABILITIES AND DEFERRED COMPENSATION

Case Overview

Issue

Could the Taxpayer partnership that sold substantially all its liabilities to a purchaser deduct the deferred compensation obligation to pay two players approximately \$10.7 million?

Held

No, IRC § 404(a)(5) defers the Taxpayer's deduction until the year in which the players include the compensation in gross income.

Key Insight

In determining the sales price in an acquisition, the seller must determine how assumed liabilities will be treated and either adjust the sales price accordingly or plan to allow the deduction to occur prior to sale.

Brief Overview

In 2012, the Taxpayer, an accrual method taxpayer, which owned the Memphis Grizzlies, sold substantially all of its assets to the purchaser. The purchaser assumed substantially all of the liabilities of the Taxpayer including the obligation to pay approximately \$10.7 million in nonqualified deferred compensation to two players.

The Taxpayer included the amount of the assumed liabilities in its amount realized from



the sale of the assets. The Taxpayer then filed an amended partnership return for 2012 claiming a deduction for the deferred compensation in the amount of approximately \$10.7 million.

Legal Analysis

The Court determined that IRC § 404(a)(5) controlled the outcome in this case and disallowed any deduction for the Taxpayer unless and until the deferred compensation is included in the gross income of the players (recipients). The Taxpayer made the argument that Treasury Regulation §1.461-4(d)(5)(i) is controlling which provides:

If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance

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requirement would have been entitled to incur as of the date of the sale, economic performance with respect to the liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

The Court disagreed, reasoning that the above quoted regulation applies where economic performance has not occurred. Here, there was no dispute that economic performance had occurred because the deferred compensation was attributable to the players' past services rendered in prior NBA seasons. The Court stated:

Therein lies the fundamental flaw in [Taxpayer's] argument: it was not §461(h)'s economic performance requirement that prevented [Taxpayer] from taking the deduction in 2012, but the rule §404(a)(5) governing nonqualified deferred compensation plans.

The Taxpayer urged the Court to consider the practical implications of its decision, that the

deduction could be lost altogether if the purchaser fails to pay the players or fails to communicate to the Taxpayer that the deferred compensation had been paid to the players. The Court responded with:

But any risk of losing the deferred compensation deduction is foreseeable, especially given the clear instructions from Congress in § 404(a)(5). We agree with the Commissioner's suggestion that [Taxpayer] could have avoided this tax-deduction problem in many ways – by adjusting the sales price to reflect deductibility, contributing to qualified plans for the players to take earlier deductions, or renegotiating the players' contracts and accelerating their compensation to the date of the sale.

Conclusion

This case shows the importance for the seller to understand how the assumption of liabilities will be treated on the acquisition of its business and plan accordingly.



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