77 T.C. 145 (1981)

A cash basis taxpayer corporation undergoing a complete liquidation under section 337 can deduct accrued but unpaid business liabilities on its final tax return when the buyer assumes those liabilities as part of the purchase price, effectively reducing the cash received by the seller.

Summary

Orem State Bank, a cash basis taxpayer, sold all its assets to Commercial Security Bank in a section 337 liquidation, with Commercial assuming Orem's liabilities. The purchase price was reduced to account for Orem's accrued but unpaid business liabilities, which would have been deductible when paid. The Tax Court addressed whether Orem could deduct these accrued liabilities on its final return. The court held that because the purchase price was reduced by the amount of these liabilities, it was equivalent to a payment by Orem, allowing Orem to deduct the accrued liabilities on its final return, despite being a cash basis taxpayer. The court distinguished this from situations where liabilities are merely assumed without a corresponding reduction in the purchase price.

Facts

Orem State Bank (Orem) was a cash basis taxpayer. Orem adopted a plan of complete liquidation under section 337. Orem sold all of its assets to Commercial Security Bank (Commercial) for $1,175,000 in cash. As part of the sale, Commercial assumed all of Orem's existing obligations and liabilities, including accrued but unpaid business liabilities. These accrued liabilities, such as interest expense, wage expense, and other operational expenses, were of a type that would have been deductible by Orem when paid. The purchase price was determined by estimating Orem's assets and liabilities as if Orem were on the accrual basis.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Orem's federal income taxes, disallowing the deduction of accrued business liabilities on Orem's final tax return. Commercial Security Bank, as transferee of Orem's assets and liabilities, petitioned the Tax Court, contesting the Commissioner's determination.

Issue(s)

1. Whether a cash basis taxpayer corporation, in a complete liquidation under section 337, can deduct accrued but unpaid business liabilities on its final income tax return when the purchaser assumes those liabilities as part of the sale, effectively reducing the cash consideration received.

Holding

1. Yes, because by accepting a reduced cash payment in exchange for the assumption of its liabilities, Orem effectively made a payment of those liabilities at the time of sale, justifying the deduction on its final return.

Court's Reasoning

The Tax Court reasoned that while a cash basis taxpayer generally deducts expenses when paid, the situation in this case was different due to the sale context. The court emphasized that the purchase price Commercial paid for Orem's assets was explicitly reduced by the amount of Orem's accrued liabilities. This reduction in cash received was considered the equivalent of Orem making a payment. The court distinguished this case from prior cases like *Arcade Restaurant, Inc.*, where the mere assumption of liabilities by shareholders in a liquidation, without a reduction in consideration, was not considered a payment. The court stated, "But in substance, by accepting less cash than it otherwise would have received, it made an actual payment to petitioner which was sufficient to justify the deductions." The court also addressed the Commissioner's concern about a potential double benefit, noting that while Commercial's basis in the assets increased by the assumed liabilities, this merely reflected the true cost of acquiring the assets, part of which was paid to Orem and part by assuming Orem's obligations. The court concluded that disallowing the deduction would be a "harsh" result and that the effective payment through reduced cash consideration justified the deduction for Orem.

Practical Implications

This case provides a significant practical implication for tax planning in corporate liquidations involving cash basis taxpayers. It clarifies that in a section 337 liquidation, a cash basis corporation can deduct accrued expenses on its final return if the buyer assumes those liabilities and the purchase price is correspondingly reduced. This ruling allows for a more accurate reflection of the liquidating corporation's income in its final taxable period, preventing a potential mismatch of income and deductions. Legal practitioners should ensure that in asset purchase agreements during corporate liquidations, the reduction in purchase price due to the assumption of liabilities is clearly documented to support the deductibility of these liabilities by the selling corporation. This case is frequently cited in tax law for the principle that economic substance, in the form of reduced consideration, can equate to payment for a cash basis taxpayer in specific transactional contexts.

