A Riddle, Wrapped in a Mystery, Inside an Enigma – The Treatment of Deferred Revenue in an Asset Acquisition

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2014—Issue 18 – It’s a tale as old as time itself: Buyer meets seller. Buyer falls in love with seller’s business. Buyer proposes to seller. Seller accepts buyer’s proposal and transfers assets to the buyer in exchange for consideration, resulting in a fairy tale ending. Part of the buyer’s consideration may include the assumption of various working-capital liabilities that are essential to the business, which may include such items as accounts payable or deferred revenue, the latter of which is the focus of this article.

As Frank Underwood might note, the nature of the treatment of deferred revenue for U.S. federal income tax purposes is that it remains immune to changing circumstances. While the rules governing the U.S. federal income tax treatment of deferred revenue in the ordinary course of business are certainly clearer than “what’s in the box,” the same cannot be said for the treatment of deferred revenue in the context of an acquisition. Much like how confusion reigned supreme at the appearance of the Red Comet over Westeros in Game of Thrones, there is conflicting guidance as to the U.S. federal income tax treatment of deferred revenue in the context of an asset acquisition. Several different methods have been endorsed by the IRS and/or the courts, but this article focuses on the following two commonly used methods that for purposes of this article will be referred to as the following: (i) the Assumption Method; and (ii) the Pierce Method.

When the Fellowship of the Ring journeyed from Rivendell to Mordor, they faced the choice of either travailing the Redhorn Pass high up in the Misty Mountains, or venturing down through the Mines of Moria. Both routes led to the same destination, but sometimes the road less traveled makes all the difference. The same might be said for the Assumption Method versus the Pierce Method, as there are subtle but important distinctions between the two that must be considered because they may have a material impact on the results to the buyer and seller.

This edition of Tax Advisor Weekly examines the treatment of deferred revenue for U.S. federal income tax purposes, and the unsettled (and unsettling) questions surrounding how it is accounted for in the context of an asset acquisition.

Overview of Deferred Revenue
Deferred revenue occurs when a customer makes a payment in advance for goods provided or services rendered (note that the terms “deferred revenue” and “advance payments” are used interchangeably throughout this article). For financial reporting purposes, the advance payment sits on the books of the recipient as a liability until the recipient of the deferred revenue has performed the necessary actions in order to satisfy the financial reporting rules related to revenue recognition.

For U.S. federal income tax purposes, an advance payment is generally included in taxable income of an accrual–method taxpayer when the payment is received (subject to certain exceptions). Therefore, there may be a book–tax difference between the treatment of deferred revenue for financial reporting purposes and U.S. federal income tax purposes. Note that for a taxpayer using the cash method of accounting for U.S. federal income tax purposes, there is generally no deferred revenue for U.S. federal income tax purposes, as all cash payments are recognized upon receipt (or constructive receipt), regardless of whether they have been earned or not. But, good news, everyone! Using its discretion, the IRS issued Revenue Procedure 2004–34, which provides for a limited deferral from recognition of certain advance payments received by accrual–method taxpayers when performance related to such advanced payments has not yet occurred. Specifically, Rev. Proc. 2004–34 provides that a portion of advance payments (as defined by the Rev. Proc.) received by qualifying taxpayers in a tax year may be deferred from recognition until the end of the following tax year if certain conditions are met.
The Assumption Method
As its name suggests, the Assumption Method contemplates the assumption of the costs associated with performing the obligations under the agreements giving rise to the deferred revenue. Here the buyer would capitalize any costs associated with fulfilling the obligation to the tax basis in the acquired assets in accordance with U.S. federal income tax rules relating to economic performance, which is generally deemed to occur when goods are provided or services are rendered.

For example, assume that a buyer acquires a seller’s business for cash of $2.5 million. The seller is an accrual—method taxpayer, and his business consists of receivables in which he has a book and tax basis equal to $2 million, and $1 million of deferred revenue with an estimated cost to fulfill such deferred revenue of $500,000. The deferred revenue has been properly deferred from recognition for U.S. federal income tax purposes pursuant to Rev. Proc. 2004–34 as detailed above. The buyer and seller agree that a value of $500,000 will be assigned to the liability for the cost to fulfill the deferred revenue obligation. Moreover, for purposes of this example, assume that the buyer and seller agree that the seller will not leave any cash on the balance sheet at close and that the purchase agreement does not specifically contemplate reducing the purchase price for the buyer’s assumption of the liability for the cost to fulfill the deferred revenue obligation. As a result, the fair market value of the acquired assets is $3 million, consisting of the cash paid of $2.5 million for the net assets and the assumption of the $500,000 liability for the cost to fulfill the deferred revenue obligation by the buyer.

Under the Assumption Method, for purchase price allocation purposes, the $2.5 million cash payment is allocated as follows: (i) $2 million to the receivables on the seller’s balance sheet; and (ii) $500,000 to goodwill that may be amortizable for U.S. federal income tax purposes. As the buyer incurs the $500,000 of fulfillment costs, such costs are added to the buyer’s tax basis in the acquired goodwill. After all of the costs of fulfillment have been incurred, the buyer is left with a tax basis in the acquired assets of $3 million (consisting of $2 million of receivables and $1 million of goodwill), which is equal to the cost to acquire the net assets at their fair market value.

The seller has an amount realized of $3 million, consisting of the $2.5 million of cash received and $500,000 of liability relief from the buyer’s assumption of the fulfillment obligation. His gain recognized is $1 million (amount realized of $3 million less the $2 million tax basis that he has in the receivables), which is entirely attributable to goodwill (since it has no tax basis) and is therefore characterized as capital gain for U.S. federal income tax purposes. Separately, the seller recognizes ordinary income of $1 million from the extinguishment of his responsibility to satisfy the deferred revenue liability and may be able to take an offsetting deduction of $500,000 related to the cost of fulfillment. The end result is that with respect to the deferred revenue liability, the seller recognizes $500,000 of ordinary income, which generally puts him in the same place from a U.S. federal income tax perspective had he never sold the business.

Many taxpayers prefer the Assumption Method because of its relative ease of implementation upon the consummation of the acquisition. However, inherent within it is a certain level of complexity on a go—forward basis, particularly with respect to the cost of fulfillment. As noted above, post—acquisition, the buyer must capitalize any fulfillment costs incurred into the tax basis of the acquired assets as such liabilities become fixed and determinable or are otherwise taken into account for U.S. federal income tax purposes. Depending on how the fulfillment costs have been taken into account for financial reporting purposes, a book—tax difference may be created that must be tracked over time. Depending on the magnitude of the cost of fulfillment and the size of the business, tracking this book—tax difference may become an onerous affair.

From a practical perspective, if the fulfillment costs are anticipated to be immaterial, which tends to be the case in certain industries, such as software companies, some taxpayers will essentially adopt a “do nothing” approach, meaning they will just follow the financial reporting treatment. Strictly speaking, this approach is not necessarily appropriate from a U.S. federal income tax perspective; however, some taxpayer have found that the benefit of adopting this simplified approach outweighs the costs associated with tracking the book—tax difference and any incremental resulting tax exposure.

The Pierce Method
The second method, eponymously named the Pierce Method from the ruling in James M. Pierce Corporation v. Commissioner, 326 F.2d 67 (8th Cir. 1969), outlines a second and unfortunately more complicated methodology for the treatment of deferred revenue in the context of an asset acquisition. The Pierce Method may apply in asset acquisitions where either:

(i) The seller makes a separate payment to the buyer as consideration for the buyer’s assumption of the deferred revenue liability or the liability for the cost to fulfill the deferred revenue obligation; or

(ii) The buyer and seller specifically agree to reduce the purchase price for the buyer’s assumption of the deferred revenue
liability or the liability for the cost to fulfill the deferred revenue obligation.

The actual payment from the seller to the buyer or the purchase price reduction (i.e., a deemed payment from the seller to the buyer) is referred to as the “Pierce Payment” in U.S. federal income tax parlance. Under the Pierce Method, a somewhat convoluted fiction is created whereby the single sale of assets is bisected into two separate transactions: the first transaction is the sale of a portion of the assets to the buyer, and the second transaction is the seller’s Pierce Payment to the buyer as consideration for assuming a deferred revenue liability or the liability for the cost to fulfill the deferred revenue obligation.

Consider the example detailed above. The buyer acquires the seller’s business for cash of $2.5 million. The seller’s business consists of receivables in which he has a book and tax basis equal to $2 million, and $1 million of deferred revenue with an agreed-upon value of $500,000 assigned to the liability for the cost to fulfill the deferred revenue obligation. All other facts are the same as above except that the purchase agreement specifically provides that the purchase price is being reduced by $500,000 (to $2.5 million) for the buyer’s assumption of the liability for the cost to fulfill the deferred revenue obligation. Under the Pierce Method, the $2.5 million of cash that the buyer paid and the $500,000 assumed liability for the cost to fulfill the deferred revenue obligation are allocated as follows: (i) $2 million to the receivables on the seller’s balance sheet; and (ii) $1 million to goodwill that may be amortizable for U.S. federal income tax purposes. Separately, there is a deemed $500,000 payment (i.e., the Pierce Payment) from the seller to the buyer as consideration for assuming the liability for the cost to fulfill the deferred revenue obligation. The buyer would report the $500,000 Pierce Payment as current ordinary income (unless eligible for deferral) and deduct the actual fulfillment costs as discussed below. The $500,000 of ordinary income therefore is offset by the $500,000 of deductible fulfillment costs, although there may be a timing mismatch between the inclusion of the Pierce Payment and the deduction of the fulfillment costs as discussed below.

Programming note: If the Pierce Method sounds like a dystopian, Kafkaesque device that may even make the likes of Rube Goldberg and Roose Bolton jealous, that’s because it might very well be as such.

Under the example above, from the seller’s perspective, the end result is no different than under the Assumption Method. The seller has an amount realized of $3 million, consisting of the $2.5 million of cash received and $500,000 of liability relief from the buyer’s assumption of the fulfillment obligation. His gain recognized is $1 million (amount realized of $3 million less the $2 million tax basis that he has in the receivables), which is entirely attributable to goodwill (since it has no tax basis) and is therefore characterized as capital gain for U.S. federal income tax purposes. Separately, the seller recognizes ordinary income of $1 million from the extinguishment of his responsibility to satisfy the deferred revenue liability and may be able to take an offsetting deduction of $500,000 related to the deemed Pierce Payment. The end result is that with respect to the deferred revenue liability, the seller recognizes $500,000 of ordinary income, which generally puts him in the same place from a U.S. federal income tax perspective had he never sold the business.

In the example above, the terms of the deal were structured such that the seller was burdened with the $500,000 of profit that was inherent within the deferred revenue ($1 million deferred revenue balance less $500,000 of fulfillment costs). Depending on the dynamics of the negotiations between the buyer and seller, the seller could theoretically shift this profit to the buyer. Using the example above, if the buyer and seller agreed to reduce the purchase price to $2 million ($3 million fair market value of net assets less the $1 million deferred revenue liability), then the seller’s Pierce Payment to the buyer would be $1 million. The seller will recognize $1 million of income from the extinguishment of his responsibility to satisfy the deferred revenue liability and an offsetting deduction of $1 million related to the deemed Pierce Payment, resulting in no incremental income. The buyer would report the $1 million Pierce Payment as current ordinary income (unless eligible for deferral) and deduct the actual fulfillment costs in the future as they are incurred. Provided that the actual fulfillment costs are $500,000, the buyer will recognize and be taxed on the resulting profit of $500,000. For this reason, depending on the relative strengths of buyers’ and sellers’ bargaining positions, sellers may prefer the Pierce Method.

Note that the Pierce Method does not require that the fulfillment costs be capitalized into the tax basis of the acquired assets. It is also important to note that the buyer only gets to deduct the fulfillment costs that are actually incurred, not estimated fulfillment costs. Therefore, if the actual fulfillment costs are less than the estimated fulfillment costs, there may be an incremental tax cost to the buyer.

Similarities and Differences Between the Assumption Method and the Pierce Method
As demonstrated above, the buyer may receive differing tax outcomes, depending on which method is selected. Under the Assumption Method, the buyer generally does not recognize any income upon the consummation of the transaction (assuming
the deferral criteria are met), and his tax basis in the acquired goodwill may or may not reflect the value of the liability for the cost to fulfill the deferred revenue obligation.

Under the Pierce Method, the buyer may have to recognize income upon consummation of the transaction (unless a deferral exception applies), but generally should receive full tax basis in the acquired assets. The actual fulfillment costs are deducted as they are incurred. If the nature of the business is such that the costs quickly turn, then this may not be an issue for the buyer, as the Pierce Payment and the fulfillment costs should offset each other. But to the extent the fulfillment costs are incurred over several years, then as noted above, there may be a timing mismatch between when the Pierce Payment is included in the buyer’s taxable income and when the deductions for fulfillment costs are recognized (resulting in deferred fulfillment cost deductions, and as others — not us — are wont to mention, “a deduction deferred, is a deduction denied”).

Alvarez & Marsal Taxand Says:
The U.S. federal income tax treatment of the assumption of deferred revenue in an asset acquisition is an area fraught with uncertainty. Taxpayers that are considering acquiring the assets of businesses with material amounts of deferred revenue should carefully consider the U.S. federal income tax impact of accounting for such deferred revenue under both the Assumption Method and the Pierce Method, and to the extent possible may want to agree with the seller up front on which method will be used and include conforming language in the purchase agreement. Buyers and sellers should also consider inserting a provision in the purchase agreement confirming the value that is to be assigned to the anticipated fulfillment costs. Caveat emptor.

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